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Public Interest Comment on Video Franchising[1]

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The Regulatory Studies Program (RSP) of the Mercatus Center at George Mason University is dedicated to advancing knowledge of the impact of regulation on society. As part of its mission, RSP conducts careful and independent analyses employing contemporary economic scholarship to assess rulemaking proposals from the perspective of the public interest. Thus, this comment on the Federal Communications Commission's (FCC's) Notice of Proposed Rulemaking on video franchising does not represent the views of any particular affected party or special interest group, but are designed to evaluate the effect of the Agency's proposals on overall consumer welfare.

I. Introduction

The FCC should be commended for opening this proceeding to identify and prevent unreasonable franchising practices.[2] Local franchising has been a mainstay of cable television regulation. Under federal law, a cable company cannot operate without a franchise, and only a local franchising authority may grant a franchise. In the early days of cable, franchises were seen as regulatory tools to deal with what was perceived as a natural monopoly. To that end, most municipalities would grant only one franchise to a monopoly cable provider. They would then try to mitigate the monopoly's market power by using the terms of the franchise. Municipal governments also found that by granting favorable franchise terms and protecting the incumbent from competitive entry, they too could share in the monopoly rents. More than two

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[1] Prepared by Jerry Brito, legal fellow, and Jerry Ellig, senior research fellow, Mercatus Center at George Mason University. This comment is one in a series of Public Interest Comments from Mercatus Center's Regulatory Studies Program and does not represent an official position of George Mason University.

[2] Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as Amended by the Cable Television Consumer Protection and Competition Act of 1992, 70 Fed. Reg. 73,973 (Dec. 14, 2005).

decades of historical data and academic research, however, have shown consistently that wireline video service is not a natural monopoly, and that cable rates are lower in areas that allow direct competition.

Acknowledging the benefits of competition, Congress in 1992 sought to eliminate the franchising barrier to entry by prohibiting local franchising authorities from unreasonably refusing to award second franchises. Nevertheless, most jurisdictions continue to be served by only one wireline video provider. Today, telephone companies and other utilities have begun to roll out video service, just as cable companies have begun to offer telephone service. The major obstacle to these initiatives, however, is the thousands of franchises that must first be negotiated and acquired. For this reason, the subject and timing of this proceeding are especially appropriate.

The principal issues in this proceeding involve defining which state laws and local franchise terms are reasonable in light of the clear pro-competitive intent of federal legislation. We believe the FCC could best promote competition and consumer welfare by taking the following steps:

1. Declare unreasonable any refusal to grant a franchise justified on the grounds of natural monopoly, reduced investment risk, or rights-of-way management unless the local franchising authority presents overwhelming empirical evidence that the alleged problem exists and cannot be solved in any way other than barring new entry.

2. Require local franchise authorities to explain in writing any refusal to grant a franchise.

3. Pre-empt aspects of state level playing field laws that force entrants to make the same capital expenditures or cover the same service area as the incumbents.

4. Declare unreasonable any state or local requirement that would force a new entrant to build out its network faster than the incumbent actually and originally built out its network.

5. Declare unreasonable any delay in granting a franchise that exceeds some specified deadline, such as 120 days. Establish simple default conditions under which a new entrant would automatically receive a franchise if the local franchising authority has not acted by the deadline.

6. Declare unreasonable any "nonprice concessions" in franchise agreements that are not directly related to setup or operation of a cable system.

II. Economic Analysis of Cable Franchising

Franchise regulation typically involves several different factors:

- **Entry**: No competitor can offer video service without the local government's permission.
- **Price**: Local authorities can regulate the price of basic cable service unless the FCC determines the local video market is competitive.
- **Nonprice concessions**: Franchise authorities often impose regulatory mandates requiring franchisees to provide a variety of services for free or at below-cost charges, such as channels for public, educational, and government access; studios for creation of public access programming; and wiring of various public facilities.
- **Fees**: Franchisees must pay the local government a fee that is limited by federal law to 5 percent of gross revenues.

A. *Franchise regulation in theory could promote the public interest*

Franchise regulation could potentially promote consumer welfare in three ways. First, if video is an "unsustainable" natural monopoly with substantial sunk costs that prevent competitive entry, then competition is inefficient, and regulation of entry and prices could promote consumer welfare. Second, protecting a cable company from competition might lower its cost of capital by lowering the risk it faces, and price regulation could pass these savings on to consumers. Third, since local governments typically own the rights-of-way used by wireline video providers, some regulation of construction and placement of wires, along with a fee that compensates the public for use of the rights-of-way, can safeguard the public's property.

1. *Natural monopoly*

Price and service regulation can improve consumer welfare if the regulated industry is a "natural monopoly"—that is, if the relationship between costs and demand makes it possible for a single firm to serve the entire market at lower cost than multiple firms—and if sunk costs eliminate the potential for entry. "Sunk costs" are costs that cannot easily be recovered if the firm decides to exit the market. If there is a natural monopoly with sunk costs, price and service regulation may mitigate the monopolist's market power.

The existence of market power, however, does not by itself justify *entry regulation.* Franchise regulation limits entry by new competitors. In most cases, if the market is a natural monopoly, then no regulation is needed to ensure that monopoly occurs. Entry regulation can improve consumer welfare only if a natural monopoly is "unsustainable"—that is, if a peculiar set of cost conditions would lead to the presence of more than one firm in the market even though a single firm can serve the entire market at lowest total cost.[3] When a natural monopoly is unsustainable, competitive entry may increase the total cost of serving consumers and lead to higher average prices than if the market was monopolized and the monopolist was forced to sell at cost-based prices.

Even if the natural monopoly is unsustainable, however, competition can have two different effects on total costs. On the one hand, competitive entry could increase total costs if a single firm, operating efficiently, could serve the entire market at lower cost. On the other hand, competitive entry might also help decrease total costs by prompting the incumbent monopolist to become more efficient in order to compete more vigorously.

The concept of sustainability must be interpreted with care because it provides an easily abused piece of rhetoric to justify restrictions on competition that benefit incumbent firms. The fact that competition may lead some firms to incur losses need not signify that the market is an unsustainable natural monopoly. Losses are entirely consistent with a competitive market; they may simply signify that a firm is not as competent a competitor. Alternatively, losses may signify that the market is a sustainable natural monopoly—and losses are the incentive that ultimately drives the less efficient firms out of the market. Therefore, losses are not sufficient evidence to demonstrate that a market is an unsustainable natural monopoly.

If entry regulation promotes consumer welfare, one would expect to see it imposed only where local governments have determined that (1) video is a natural monopoly, (2) the natural monopoly is "unsustainable," (3) the monopoly will not waste the cost savings by becoming lax, and (4) price regulation will effectively pass the cost savings through to consumers. If all of those conditions hold, prices and service quality in markets where franchise regulation prevents competition should be at least as good as in markets where competition exists. If any of those conditions do not hold, however, franchise regulation of entry is at best superfluous and at worst a source of market power and increased consumer costs.[4]

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3 *See* WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE ___ (1982).

4 For a sample of the economics literature outlining the perverse incentives created when economic regulation substitutes for competition, *see* Thomas W. Hazlett, *Competition vs.*

2. *Risk reduction*

A second, distinct argument for entry regulation is that it can lead to lower prices for consumers when producers must invest in long-lived, specialized capital equipment that has little resale value. An industry or market requiring such investments need not be a natural monopoly. The price depends in part on the producer's cost of capital, which in turn depends on risk. Partially or fully protecting the producer from competition could reduce its risk, thereby lowering the cost of capital.[5] Effective price regulation could pass these cost savings through to consumers. If these price savings are sufficiently large, consumers might be better off with competition limited by entry regulation than they would be if competition were unrestricted.[6]

Under this theory, two conditions must hold if entry regulation is to improve consumer welfare. First, the potential price reductions that result from the reduction in the cost of capital due to the suppression of competition must be larger than the expected cost reductions that would occur as a result of unrestricted competition and innovation. It is unclear whether this is possible even in theory.[7] Second, price regulation or some form of binding contract must effectively pass these cost reductions through to consumers.

Empirically, the "specialized capital" theory implies that if entry regulation benefits consumers, we should observe lower cable prices or better service quality in jurisdictions where entry is controlled than in jurisdictions where competition was unrestricted at the time cable systems were first built or substantially upgraded.

3. *Rights-of-way management*

A third reason that franchise regulation might promote the public interest is that it gives local authorities a mechanism to manage the public rights-of-

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Franchise Monopoly in Cable Television, 4 CONTEMP. POL'Y ISSUES 80 (1986); Thomas W. Hazlett, *Prices and Outputs Under Cable TV Reregulation*, 12 J. OF REG. ECON. 173 (1997); Thomas W. Hazlett, *The Demand for Regulated Franchise Monopoly: Evidence from CATV Rate Deregulation in California*, 29 ECON. INQUIRY 285 (1991).

[5] Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON. 427, 432 (1976).

[6] *Id.* at 435.

[7] *See, e.g.*, Robert B. Ekelund, Jr. & Richard S. Higgins, *Capital Fixity, Innovations, and Long-Term Contracting: An Intertemporal Economic Theory of Regulation*, 72 AM. ECON. REV. 32, 44 (1982) (finding that the *expected* price consumers pay under entry regulation is no better than the expected price they pay under unrestricted competition, and therefore regulation is preferred only if consumers are risk-averse).

way.[8] The economic justification for public management of the rights-of-way is that it reduces transactions costs that might otherwise make certain uses of those rights-of-way unfeasible.[9] Municipal control over the rights-of-way, for example, allows utilities to more cheaply secure rights to use them than if the utility had to negotiate with many individual property owners. Additionally, unitary public control avoids hold-up problems.

The public rights-of-way are a scarce resource. If there are no restrictions on the way that utilities may make use of that resource, then there will be congestion.[10] Such congestion can impose significant costs on the public or other users in forms as diverse as misallocation of space, crowded utility ducts, or blight. Congestion can be addressed by instituting a cost-based charge calibrated to prevent overuse. The existence of scarcity by itself, however, does not justify limiting entry through franchising to only one firm.

Nevertheless, franchise regulation is one method by which a locality can regulate access to the public rights-of-way and impose congestion pricing. A franchise fee would be justified if it were "reasonably calculated to cover the cost that a given use of the public way imposes on either the municipality or the other users of the public way."[11] However, the efficient management of the public ways does not justify the imposition of a franchise fee that exceeds the costs that result from a franchisees' use of the rights-of-way. A franchise fee that merely maximizes revenues for the local government could easily exceed the cost-based charge needed to prevent congestion of the rights-of-way. Neither does rights-of-way management justify government control over the content, quality, or price of video service, because such regulation would have nothing to do with either transaction costs or congestion. There may be many reasons to impose these types of regulations, but management of public rights-of-way is not one of them.

B. *Franchise regulation in practice has harmed consumers*

[8] In fact, Title VI of the Communications Act of 1934, which regulates video, limits the obligation to obtain a franchise to those operators that use a "public right-of-way." 47 U.S.C. 522(7)(B) (2000). The Act's legislative history further states that "[t]he premise for the exercise of . . . local jurisdiction over cable systems continues to be [the] use of local streets and rights of way." S. REP. NO. 97-518, at 5 (1982).

[9] George L. Priest, *The Origins of Utility Regulation and the "Theories of Regulation" Debate*, 36 J.L. & ECON. 289, 306 (1993).

[10] Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55, 62 (1968); Gardner F. Gillespie, *Rights-of-Way Redux: Municipal Fees on Telecommunications Companies and Cable Operators*, 107 DICK. L. REV. 209, 220-21 (2002).

[11] Diginet, Inc. v. W. Union A.T.S., Inc., 958 F.2d 1388, 1399 (7th Cir. 1992).

In theory, well-designed franchise regulation might promote consumer welfare under certain circumstances. In practice, franchise regulation has fostered monopoly and raised cable rates, with local governments sharing in the monopoly profits. As Hazlett has noted:

> Municipal governments discovered that they could extract substantial rents by awarding licenses on favorable terms to the applicant. In the 1960s, New York Mayor John Lindsay proclaimed cable franchises "urban oil wells beneath our city streets." This produced a decided bias in favor of monopoly, which would improve expected returns and so raise the "bid" from prospective applicants.[12]

Entry regulation by local franchising authorities is, of course, just one factor that might hamper wireline video competition. A Government Accountability Office (GAO) case study of new competitive broadband service providers (BSPs), which offer both video and Internet service, identified several factors that influence these new entrants' decisions to compete in a given market. Most of the competitors preferred small or medium-sized markets where they could complete their buildout quickly. Some preferred high-income markets, while others thought a diversity of income levels raised their odds of selling at least one service to many households. All tended to choose markets close to their headquarters, parent company, or other infrastructure they owned.[13] Such considerations are similar to those that face any kind of startup company that builds a network infrastructure offering a consumer service.

In addition, the BSPs also said they tend to choose cities where local officials actually welcome competition and make the franchising process easy. Key barriers identified by the competitors include lengthy processing times for franchise applications, franchise fees, the cost of construction permits, and state "level playing field" laws, which require new franchisees to agree to terms and conditions at least as onerous as those imposed on the incumbent.[14] Cities eager to see new competition have approved franchise agreements in as little as 120 days, whereas competitors have abandoned their applications in other cities after waiting two and one-half years.[15] Even seemingly symmetric requirements can actually disadvantage competitors. For example, requiring a competitor to meet the same buildout schedule in

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[12] Thomas W. Hazlett, *Cable Television*, in HANDBOOK OF TELECOMMUNICATIONS ECONOMICS: TECHNOLOGY EVOLUTION AND THE INTERNET, VOL. 2, __ (Sumit K. Majumdar et al. eds., Elsevier Science 2006).

[13] GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: WIRE-BASED COMPETITION BENEFITED CONSUMERS IN SELECTED MARKETS 20-21 (2004).

[14] *Id.*

[15] *Id.*

the entire service area as the incumbent ignores the fact that the incumbent likely fulfilled this requirement when the metropolitan area was smaller, and then gradually added facilities as population grew.[16] At the very least, BSPs view restrictive franchising as one significant factor that discourages market entry.

Other potential entrants into the video market—such as telephone companies using fiber optic or DSL, or electric utilities employing broadband over powerlines—are much less likely to face the non-franchise difficulties identified by the BSPs. Phone and power companies are not startups. They already have substantial facilities in place, and they likely have much better access to capital than the BSPs. Phone and power companies can surmount many barriers affecting the BSPs—but the franchising barrier remains.

Franchise regulation has harmed consumer welfare by excluding competitors, forcing cable companies to offer "nonprice concessions" that increase consumer costs, and imposing franchise fees that also increase consumer costs.

1. *Anticompetitive exclusion*

Substantial evidence from the history of cable franchising demonstrates that entry regulation was not surgically applied to remedy proven market failures, but rather adopted as a general policy almost everywhere. The result was to create market power and entrench cable monopolies.

If entry regulation is a remedy for unsustainable natural monopoly or reduces cable companies' costs, then monopolized video markets should have lower costs, lower prices, and perhaps better quality than competitive markets. Several decades of studies reveal that precisely the opposite is the case.

One need look no further than the FCC's most recent report on cable prices for some highly suggestive evidence. The report, released in February 2005, breaks down a variety of cable rates based on whether, and what type, of competition the FCC has determined the incumbent faces. As Table 1 shows, during the past several years, the price of a package including basic, expanded basic, and equipment rental has been between 12 and 15 percent lower in markets where the FCC has determined the incumbent faces effective competition from another wireline video provider. Since competition also spurs cable companies to include more channels in the expanded basic package, the difference in the price consumers pay per channel is even larger—between 19 and 22 percent.

[16] *Id.* at 25.

Table 1: Cable Rates for Basic, Expanded Basic, and Equipment Rental

		Monthly Rate of Basic + Expanded Basic + Equip't		Channels		Price Per Channel	
		Non-Compet.	Wire Compet.	Non-Compet.	Wire Compet.	Non-Compet.	Wire Compet
2002		$39.97	$34.89	NA	NA	NA	NA
	% difference		**-12.71**				
2003		$43.14	$37.22	67.3	71.2	$0.657	$0.528
	% difference		**-13.72**		**5.79**		**-19.63**
2004		$45.56	$38.80	70.1	74.9	$0.665	$0.523
	% difference		**-14.84**		**6.85**		**-21.35**

Source: FCC, Report on Cable Industry Prices (2005), Attachments 7-9.

Statistics on digital cable, shown in Table 2, tell a similar story. During the past several years, the price of the digital tier has been 3 to 6 percent lower in markets with wireline video competition, and the price per channel has been 6 to 13 percent lower. In 2004, several other charges were also lower on average in markets with wireline video competition: reconnection ($26.76 vs. $28.71) and installation in an unwired residence ($43.00 vs. $45.19). Only installation in a previously wired residence was less expensive in markets without wireline competition—by 33 cents ($31.57 vs. $31.24).[17]

Table 2: Digital Cable Rates

		Monthly Rate of Digital Tier		Channels		Price Per Channel	
		Non-Compet.	Wire Compet.	Non-Compet.	Wire Compet.	Non-Compet.	Wire Compet
2002		$14.56	$13.68	NA	NA	NA	NA
	% difference		**-6.04**				
2003		$15.29	$14.56	27.3	28.8	$0.686	$0.641
	% difference		**-4.77**		**5.49**		**-6.56**
2004		$16.09	$15.64	31.4	33.8	$0.588	$0.513
	% difference		**-2.80**		**7.64**		**-12.76**

Source: FCC, Report on Cable Industry Prices (2005), Attachments 12-14.

[17] Federal Communications Commission, Report on Cable Industry Prices (2005), Attachment 11.

These average price comparisons may be vulnerable to two criticisms. First, the various competitive categories are based on past FCC determinations of whether the incumbent faces effective competition from various sources, including wireline, wireless, and direct broadcast satellite. Incumbents have to petition for these findings, and a finding of effective competition releases the incumbent from regulation of basic cable rates.[18] It is possible, therefore, that some markets where the incumbent faces competition are in the "noncompetitive" category because they have never petitioned for a finding that they face effective competition. Alternatively, the FCC might classify some markets as "competitive" even if the competitor has disappeared. For these reasons, the raw price comparisons may either under- or overstate the effect of wireline video competition on rates.[19]

A second criticism is that looking at raw data does not control for other factors that might affect cable rates. If, for example, markets with multiple competitors have population patterns or geography that make them less expensive to serve, then those underlying factors might be responsible both for the lower rates and for the presence of competitors. Econometric analyses that control for other factors, however, consistently find that video markets with more competition have lower prices and better service packages.

In April 2005, the GAO released an analysis of 2004 cable rate data that corrected for both potential problems. GAO's econometric analysis found that wireline cable competition reduced cable rates by 16.9 percent. The cable rate measure in GAO's study was the total price of basic, extended basic, and converter box rental—similar to the figure listed in Table 1 above.[20] GAO omitted franchise areas with competition from a municipal cable company;[21] thus, the analysis avoids confusing the effects of competition with the effects of possible municipal subsidies. GAO's analysis found that private wireline competition had an even bigger effect on prices than the FCC's raw data might indicate. In addition, GAO found that regulation of basic cable rates

[18] 47 C.F.R. § 76.905-07 (2005).

[19] For elaboration of this criticism and the FCC's response, *see* GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: ISSUES RELATED TO COMPETITION AND SUBSCRIBER RATES IN THE CABLE TELEVISION INDUSTRY 16-18 & 70-79 (2003).

[20] GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: DIRECT BROADCAST SATELLITE SUBSCRIBERSHIP HAS GROWN RAPIDLY, BUT VARIES ACROSS DIFFERENT TYPES OF MARKETS 31 (2005). The results are very similar to those found in previous runs of GAO's model, such its October 2003 report. *Supra* note 19.

[21] GOVERNMENT ACCOUNTABILITY OFFICE, TELECOMMUNICATIONS: DIRECT BROADCAST SATELLITE SUBSCRIBERSHIP HAS GROWN RAPIDLY, BUT VARIES ACROSS DIFFERENT TYPES OF MARKETS 29 (2005).

has no statistically significant effect on rates,[22] which suggests that rate regulation is largely ineffective at controlling monopoly pricing.

Further evidence comes from a 2004 GAO case study that compared six markets having competing broadband service providers with six similar markets lacking such competition. GAO found that in five of the six competitive markets, expanded basic cable rates were lower than in similar markets without such competition. Rate differences ranged from 15 to 41 percent. Telephone service cost between 4 and 33 percent less in five of the markets, and about the same in the remaining one. High-speed Internet service cost 20 to 38 percent less in three of the markets with competition, and about the same in the other three.[23] On average, rates for a package of cable, high-speed Internet, and telephone service were 15 percent lower in the markets with competition.[24]

Incumbent cable operators have responded to competition with more than just price reductions. Faced with competition from direct broadcast satellite in the mid-1990s, which offered a digital signal, cable operators nearly doubled their bandwidth, from 450 MHz to 750 MHz, and offered their own digital service.[25] When direct broadcast satellite carries local broadcast channels, and hence becomes a closer substitute for cable, cable operators offer about 5 percent more channels than elsewhere.[26] The GAO case study of broadband service providers, meanwhile, found that cable companies tend to respond to these new competitors by lowering prices, expanding service offerings, and improving customer service.

These kinds of results are consistent with findings of earlier studies:

- A monograph on the economics of cable TV cites 11 different studies or surveys conducted between 1984 and 1992 that find wireline cable competition reduces cable prices by between 8 percent and 34 percent.[27]
- The FCC's 2002 econometric study found that the presence of wireline video competition reduces cable rates by 5.4 percent.[28]

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[22] *Id.* at 31.

[23] GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 13, at 15-16.

[24] *Id.* at 12.

[25] Hazlett, *supra* note 12, at __.

[26] GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 19, at 59-61.

[27] THOMAS W. HAZLETT & MATTHEW L. SPITZER, PUBLIC POLICY TOWARD CABLE TELEVISION: THE ECONOMICS OF RATE CONTROLS 30 (1997).

[28] FEDERAL COMMUNICATIONS COMMISSION, REPORT ON CABLE INDUSTRY PRICES 29 (2002).

- A study using 1998 FCC cable rate survey data found that wireline competition reduces cable rates by 10.3 percent and increases the number of cable channels by 5.4 percent.[29]
- Emmons and Prager estimate that about 20 percent of the price of basic cable service in both 1983 and 1989 consisted of monopoly profits, which implies that monopoly inflated basic cable rates by about 25 percent. Since their study covered years in which cable rates were regulated and unregulated, they conclude that regulation did little to control monopoly pricing.[30]
- Using 1989 data, Beil et al. conducted an empirical study comparing competitive and monopoly local franchise areas and concluded that competition lowers the average basic cable bill by about $3.85 and premium pay cable services by $1.10.[31] They estimate that monopoly franchising results in roughly $3.6 billion per year in deadweight loss.
- Similarly, in 1991 Levin and Meisel compared localities that had cable competition with jurisdictions that were "similar in most respects except for the presence of competition."[32] Controlling for other variables, such quality, they found that subscribers of competitive cable companies paid between $2.94 and $3.33 less per month for service.[33]
- Hazlett and Spitzer found that while the national monthly average revenue per subscriber in 1992 was $32.12 for a full cable package, an April 1992 survey of 103 cable systems competing head-to-head in 50 markets showed that their average revenue per subscriber was $25.08.[34] That figure implies that competitive systems where pricing about 21 percent lower. Hazlett and Spitzer also point out that because competitive firms offer a higher number of channels on average, the per-channel rate differences are even larger.

[29] John Agyei Karikari et al., *Subscriptions for Direct Broadcast Satellite and Cable Television in the U.S.: An Empirical Analysis*, 15 INFO. ECON. & POL'Y 1, 11 (2003).

[30] William M. Emmons & Robin A. Prager, *The Effects of Market Structure and Ownership on Prices and Service Offerings in the U.S. Cable Television Industry*, 28 RAND J. ECON. 743, 741 & 746 (1997).

[31] Richard O. Beil et al., *Competition and the Price of Municipal Cable Television Services: An Empirical Study*, 6 J. OF REG. ECON. 401, 413 (1993).

[32] Stanford L. Levin & John B. Meisel, *Cable Television and Competition: Theory, Evidence and Policy*, 15 TELECOM. POL'Y 519, 523 (1991).

[33] *Id.* at 525.

[34] Hazlett & Spitzer, *supra* note 27, at 27-28.

- In 1986, Hazlett found that in areas with two or more overlapping cable systems, monthly bills for basic cable and HBO were about $1.82 lower than in localities with only one cable franchisee.[35]
- In an empirical analysis looking at direct broadcast satellite (DBS) penetration relative to cable penetration, Karikari et al. show that in franchise areas that included cable overbuilders, cable penetration increased by about 59 percent while DBS penetration decreased by about 49 percent.[36] The authors conclude that DBS entry was discouraged in competitive markets because wireline competition produces lower cable rates and increased competition in the number of channels offered.

Economic research demonstrates conclusively that wireline video competition leads to lower prices and improved quality. These findings undercut the natural monopoly justification for entry regulation, which posits that the market can be served at lowest cost by a single firm. They also cast doubt on the "specialized capital" justification. Even when cable was first deployed in major population centers, jurisdictions with open entry policies had rates no higher than state or national averages, and jurisdictions with competing cable systems had rates lower than monopolized jurisdictions. Open entry and competitive jurisdictions often had much higher cable penetration rates, suggesting that cable service was deployed faster or was of higher quality than in monopoly jurisdictions.[37]

Finally, the fact that different scholars using different data and different methods have reached the same conclusion over the course of two decades also undermines any claims that the competition and low prices are transitory, "unsustainable" phenomena. The benefits of video competition are conclusive.

2. *Nonprice Concessions*

Regulatory mandates that are part of a franchise increase costs and prices. Franchises granted by local authorities often include many nonprice concessions by the cable operator. These include such things as free wiring and connection of local public institutions, community programming capacity that includes studio space and equipment for local government use, institutional networks linking different government facilities such as the fire department and city hall, excess channel capacity, and other perquisites.

[35] Thomas W. Hazlett, *Competition vs. Franchise Monopoly in Cable Television*, 4 CONTEMP. POL'Y ISSUES 80, 91 (1986).

[36] Karikari et al., *supra* note 29, at 10-11.

[37] Hazlett, *supra* note 35, at 84-87 & 90-91.

Such mandates are especially dangerous for consumers because, unlike franchise fees, they are not effectively regulated by federal legislation. Indeed, even though the 1984 Cable Act now prevents localities from charging franchise fees in excess of 5 percent, a local franchising authority can now simply demand more in-kind services instead.[38]

A 1984 survey of cable operators showed that nonprice concessions significantly raise cable costs. According to the study, nonprice concessions accounted for 26 percent of building costs and 11 percent of operating expenses.[39] Additionally, the survey found that much of the capacity created as a result of the nonprice concessions goes largely unused, and operators indicated that they would never freely invest in such systems.[40] The local community programming very often required by franchisors—known as PEG (public, education, and government) channels—has little or no effect on demand for cable. "Televised city council meetings and local high school football games simply do not sell many subscriptions for an operator."[41]

In effect, nonprice concessions are a vehicle by which local officials tell the franchised monopolist, "You may exploit your power to raise prices as long as you spend some of the extra money on services that consumers may not be willing to pay for." They thus contribute to the measured increase in cable rates associated with monopoly discussed in the previous section.

3. *Franchise fees*

Franchise regulation also involves fees, the costs of which are passed through to consumers. Federal regulation limits franchise fees to five percent of a cable company's gross revenues from the sale of video services. The five percent franchise fee acts as an excise tax on services sold by companies that hold cable franchises. To the extent that this fee merely reimburses the local government for costs associated with the video provider's use of the public rights-of-way, it provides an accurate price signal that makes cable firms take these costs into account. To the extent that the fee exceeds the actual costs, then it simply forces the price of video service higher and gives the local government a stake in higher prices.

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[38] Hazlett, *supra* note 12, at __.

[39] Mark A. Zupan*, The Efficacy of Franchise Bidding Schemes in the Case of Cable Television: Some Systematic Evidence*, 32 J.L. & ECON. 401, 405 (1989).

[40] *Id.* at 405-6.

[41] *Id.* at 406.

The data on cable rates gathered in FCC surveys do not include the cost of franchise fees.[42] Thus, the maximum five percent fee imposes an additional cost on consumers over and above the price increases identified in the GAO studies.

C. *An estimate of the total costs of franchise regulation*

Anticompetitive exclusion, cost-increasing mandates, and franchise fees all affect consumer welfare. They do so in two distinct ways. The price increases transfer wealth from consumers to cable firms and local governments. In addition, consumers purchase and use less cable service in response to the price increase. The value consumers forego because less service is purchased is an important, but hidden, cost of regulation.

1. *Price increases and wealth transfers*

The price increase transfers money from consumers to cable companies and/or local governments. Economists call this effect the "wealth transfer." It is equal to $\Delta p \cdot q$, where Δp is the price increase caused by regulation and q is the amount of service purchased.

For cable franchising, Δp is the sum of two costs:
(a) the price increase that occurs because of market power, and

(b) the 5 percent franchise fee.

Item (a) includes both the effects of anticompetitive exclusion and the effects of the nonprice concessions that the cable company made in order to get the franchise. Exclusion of wireline competitors allows the cable company to exercise some degree of market power. It gets to keep some of the extra revenue as profit, but it also committed to spend some of the extra revenue on nonprice concessions in order to receive the franchise. To the extent that local authorities extract nonprice concessions from competitive wireline video providers, our calculations underestimate the effect of nonprice concessions on prices paid by consumers.

a. Price increase due to market power

We can calculate (a) from data and studies that assess the effect of wireline video competition on cable rates. The most recent and careful study appears to be the 2005 GAO study, which uses 2004 data to estimate that wireline

[42] Telephone Interview, Industry Analysis Division, Media Bureau, Federal Communications Commission (Jan. 27, 2006). This is also implied by the fact that the federal law allows cable operators to list the franchise fee as a separate line item on cable bills. 47 U.S.C. § 542(c) (2000).

video competition reduces monthly cable rates by about 16.9 percent.[43] GAO's statistical approach draws upon, and is consistent with, best practices in the scholarly literature. In 2004, the monthly rate for basic, expanded basic, and equipment rental in markets without wireline competition was $45.52—virtually identical to the weighted average of $45.56 in all markets the FCC designated as "noncompetitive."[44] A 16.9 percent reduction equals $7.69 per month.

According to FCC data, 3.09 percent of cable subscribers are in markets with wireline video competition.[45] Total cable subscribership stood at 66.1 million in 2004.[46] Therefore, approximately 2 million cable subscribers were in markets with wireline video competition, leaving about 64 million in markets without wireline video competition. If these 64 million consumers paid an average of $7.69 more per month than they would have paid in the presence of wireline video competition, the wealth transfer from the price increase on basic, extended basic, and equipment rental totaled $5.9 billion in 2004.

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[43] Technically, the actual price difference might be slightly smaller. GAO's model estimates the effect of wireline competition on cable prices, but it also estimates the effects of cable prices on direct broadcast satellite penetration, and the effect of direct broadcast satellite penetration on cable prices. Since wireline competition lowers cable prices, it also lowers direct broadcast satellite penetration, and this reduction tends to increase cable rates. Using the coefficients estimated in GAO (2005), *supra* note 21, at 31, the price difference in competitive markets after adjusting for the satellite effect would be 16.5 percent. GAO's model estimates that a 1 percent reduction in cable rates leads to a .4582 percent reduction in satellite penetration, and a 1 percent reduction in satellite penetration leads to a .0476 percent increase in cable rates. Thus, 16.9 percent x .4582 percent x .0476 percent equals 0.37 percent. Subtracting 0.37 percent from 16.9 percent yields 16.52 percent.

[44] Calculated from figures in FEDERAL COMMUNICATIONS COMMISSION, REPORT ON CABLE INDUSTRY PRICES (2005), Attachment 1, and subscribership information in FEDERAL COMMUNICATIONS COMMISSION, CABLE COMPETITION REPORT (2005), Appendix B, Table B-1. Other markets the FCC deemed competitive were those where the incumbent was found to face adequate competition from DBS or wireless cable, or where the incumbent had a penetration rate below a designated threshold. The weighted average price for all of these markets lacking wireline competition is about the same as in noncompetitive markets because prices in markets with competition from wireless cable are actually higher than prices in noncompetitive markets.

Since the FCC averages may suffer from inaccuracies identified in *supra* note __ a more accurate calculation would use averages for noncompetitive and wireline competition markets derived from the GAO's (2005) data set. Unfortunately, GAO's data set includes some proprietary data that are not available to the public, so the FCC figures are the best available to us.

[45] FEDERAL COMMUNICATIONS COMMISSION, REPORT ON CABLE INDUSTRY PRICES (2005), Attachment 1.

[46] FEDERAL COMMUNICATIONS COMMISSION, CABLE COMPETITION REPORT (2005), Appendix B, Table B-1.

FCC data also permit an estimate of the wealth transfer that occurs because incumbents who do not face wireline video competition can charge higher prices for digital cable. The weighted average price of the digital tier in markets lacking wireline video competition equals $16.06 per month, versus $15.64 in the markets with wireline video competition. The $5.00/year difference, multiplied by an estimated 22.5 million digital subscribers, yields a wealth transfer in 2004 of $113 million.[47]

We have found no data from recent years that would let us assess whether franchising restrictions allow incumbent cable operators to charge higher prices for premium channels. To the extent that they can do so, our calculations understate the effects of market power on prices paid by consumers.

b. *Franchise fee*

The franchise fee applies to all cable consumers, not just those in the markets that lack wireline video competition. If cable operators did not have to pay a five percent franchise fee,[48] and if competition forced them to pass this cost saving through to consumers, then cable rates would be approximately 4.8 percent lower than the figures in the FCC's survey.[49] The weighted average rate for basic, extended basic, and equipment rental in 2004 was $45.32.[50] Without the franchise fee, the price would be 4.8 percent less, or $43.14. The $2.18 per month savings, multiplied by 66.1 million cable subscribers plus 1.4 million video customers of competitive "broadband service providers," yields an annual wealth transfer of $1.77 billion—just for basic, extended basic, and equipment rental.

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[47] Calculated from data on total subscribership, digital subscribership, and digital tier price in FCC, REPORT ON CABLE INDUSTRY PRICES (February 2005), Attachments 12 and 16, and FCC, CABLE COMPETITION REPORT (2005), Appendix B, Table B-1.

[48] Federal law prohibits franchise authorities from charging a franchise fee that exceeds 5 percent of gross revenues. Some franchise authorities may charge less than this maximum, but we have found no good recent data that would show whether a significant number of authorities charge much less than 5 percent. Zupan's survey found that franchise fees average 4.26 percent of cable companies' operating expenses. Zupan, *supra* note 39, at 405. In any case, the figure for total franchise fee revenues we use is the total figure calculated by the National Cable and Telecommunications Association, which exceeds the figure we calculate just for basic, extended basic, and equipment rental.

[49] The observed prices equal the price without the fee times 1.05. Hence, the price without the fee equals the observed price divided by 1.05, which is equivalent to multiplying the observed price by .952. The price without the fee would, therefore, be 4.8 percent less than the observed price that includes the franchise fee.

[50] FEDERAL COMMUNICATIONS COMMISSION, *supra* note 17, at 3.

The franchise fee, however, applies to cable companies' gross video service revenues, which includes premium channels. The National Cable & Telecommunications Association (NCTA) estimates that cable companies paid $2.4 billion in franchise fees in 2004.[51] We use this figure as our estimate of franchise fees, even though it may slightly understate the total by omitting franchise fees paid by competitive wireline video providers.

c. Total wealth transfer

The total wealth transfer can be calculated as follows:

Price increase for basic, expanded basic, and equipment rental:	$5.9 billion
Price increase for digital cable:	$113 million
Price increase due to franchise fees:	$2.4 billion
TOTAL:	$8.4 billion

[51] NATIONAL CABLE & TELECOMMUNICATIONS ASSOCIATION, 2005 MID-YEAR INDUSTRY OVERVIEW 22 (2005).

2. *Forgone consumer benefits*

In addition to taking money from consumers and giving it to cable companies and local governments, the price increase caused by franchise regulation leads to changes in consumer behavior. When consumers purchase less of a service because prices are higher than they would otherwise be, consumers are worse off. Their loss can be measured by the difference between the value of the service to them and the price they would have paid. Economists call this difference the "consumer surplus" forgone as a result of the price increase.

The value of the forgone consumer surplus can be calculated as $.5 \cdot \Delta p \cdot \Delta q$.[52] The term Δp refers to the price increase caused by franchise regulation, and Δq is the reduction in quantity sold due to the price increase. In other words, the forgone consumer surplus equals approximately one-half of the change in price induced by regulation times the change in quantity induced by the price change.

The trickiest aspect of these calculations—aside from actually getting the relevant data—is ascertaining how much of a change in quantity occurs as a result of a regulation-induced price change. The change in quantity can be calculated from the change in price with the aid of an estimate of the price elasticity of demand. The price elasticity of demand measures how responsive quantity is to price. It is equal to the percentage change in quantity divided by the percentage change in price. The elasticity of demand is defined as $(\Delta q/q)/(\Delta p/p)$. If one has an estimate of the elasticity and also the values of p, Δp, and q, then one can solve algebraically for Δq and then estimate the forgone consumer surplus.

Virtually every study of cable television demand finds that demand is very responsive to price. During the past 25 years, studies have produced demand elasticity estimates ranging from -1.5 to as high as -5.9. Most fall in the range between -2.4 and -3.[53] This is consistent with the results of FCC research in 1994, which found five estimates of the elasticity of demand that ranged from 1.31 to 3.38, with a mean value of 2.03.[54] The FCC's 2002 econometric

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[52] See Jerry Hausman & Howard Shelanski, *Economic Welfare and Telecommunications Regulation: The E-Rate Policy for Universal-Service Subsidies*, 16 YALE J. ON REG. 19, 40 (1999).

[53] GEORGE S. FORD & THOMAS M. KOUTSKY, FRANCHISE FEE REVENUES AFTER VIDEO COMPETITION: THE "COMPETITION DIVIDEND" FOR LOCAL GOVERNMENTS, (Phoenix Policy Center, Bulletin No. 12, Nov. 2005), at 8.

[54] Hazlett, *supra* note 12, at 24. *See also* BRUCE M. OWEN & STEVEN S. WILDMAN, VIDEO ECONOMICS 231 (1992) (reporting a study that found elasticities ranging from 1.6 to 3.4).

analysis found an elasticity of -2.19.[55] The most recent study, published by GAO in 2005, found an elasticity of -2.63, which is very close to the -2.7 figure calculated by Hazlett using data on the cable industry's 2001 cash flow margin.[56]

All of the relevant data on monthly cable rates and subscribership can be found in either FCC reports or independent scholarly studies. Unfortunately, the available data cover only basic, extended basic, and equipment rental—the "monthly cable rate" discussed in FCC surveys and the GAO studies. Our estimate will therefore understate the forgone consumer surplus, perhaps by a great deal, because it will not include any forgone consumer value due to reduced purchases of digital cable or premium channels that may result from franchise regulation.

The forgone consumer surplus must be calculated separately for markets that have wireline video competition and markets that lack wireline video competition. For the markets that lack wireline video competition, Δp is the sum of two costs:

(a) the price increase that occurs because franchising gives incumbent cable companies market power, and

(b) the 5 percent franchise fee.

For markets that have wireline video competition, Δp includes only the franchise fee.

Table 3 shows the wealth transfer, deadweight loss, and total cost to consumers under different assumed values of the elasticity of demand. Regardless of the elasticity, the total cost to consumers is approximately $10 billion annually, or approximately $150 per subscriber.[57] Table 4 shows the cost to consumers excluding the effects of franchise fees, which are set by federal legislation. Excluding franchise fees, franchising generates a total annual consumer cost of about $7 billion, or $104 per subscriber.[58]

Table 3: Cost to Consumers of Franchising (including franchise fees)

Elasticity of Demand	Wealth Transfer	Forgone Consumer Surplus (DW Loss)	Total Cost to Consumers
-1.5	$8.4 billion	$1.2 billion	$9.6 billion
-2.0	$8.4 billion	$1.7 billion	$10.1 billion

[55] FEDERAL COMMUNICATIONS COMMISSION, *supra* note 28, at 29.

[56] GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 21, at 31; Hazlett, *supra* note 12, at __.

[57] $10 billion divided by approximately 67 million cable subscribers.

[58] $7 billion divided by approximately 67 million cable subscribers.

-2.5	$8.4 billion	$2.1 billion	$10.5 billion

Table 4: Cost to Consumers of Franchising (excluding franchise fees)

Elasticity of Demand	Wealth Transfer	Forgone Consumer Surplus (DW Loss)	Total Cost to Consumers
-1.5	$6 billion	$750 million	$6.75 billion
-2.0	$6 billion	$1 billion	$7 billion
-2.5	$6 billion	$1.3 billion	$7.3 billion

One "reality check" on these figures involves comparing our projections of subscribership under ubiquitous wireline video competition to the total number of households and housing units in the nation. The Census Bureau estimates that there were 112 million households in 2004.[59] A single household may, of course, have more than one cable subscription, either because some family members subscribe separately or because the household has more than one residence. The Census Bureau estimates that there were about 121 million housing units in the United States in 2003, the most recent figure available.[60] Our calculations imply that ubiquitous wireline video competition would increase total cable plus broadband service provider subscriptions from 67 million to between 88.5 and 102.6 million, depending on the elasticity of demand. The higher estimate implies close to universal cable subscription.

Some of these new cable subscribers would be households that currently rely on broadcast. A significant portion might also be some of the 23 million households that currently receive video from direct broadcast satellite. Indeed, the 2005 GAO study finds that lower cable prices are associated with a lower percentage of households subscribing to satellite.[61] The satellite firms might stem some of the market share loss by cutting their own prices, and so cable subscriptions might not rise by as much as our calculations suggest. In that case, some of the consumer savings would accrue to consumers who subscribe to satellite. Given that satellite providers tend to offer nationwide pricing plans, the consumer benefits might even be larger than we estimate if satellite providers reduce their prices in response to lower cable rates.

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[59] U.S. CENSUS BUREAU, *Current Population Survey, 2004 Annual Social and Economic Supplement*, *at* http://www.census.gov/population/socdemo/hh-fam/cps2004/tabH1-all.csv (last visited Feb. 6, 2006).

[60] U.S. CENSUS BUREAU, *American Housing Survey for the United States: 2003, Table 1A-1. Introductory Characteristics—All Housing Units*, *at* http://www.census.gov/hhes/www/housing/ahs/ahs03/tab1a1.htm (last visited Feb. 6, 2006).

[61] GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 21, at 31.

III. The FCC's Options

The FCC might be able to address the problems that local franchising presents to competition in two ways. First, it could declare that local telephone companies (telcos), which are now entering the video market, are not subject to the regulations that apply to cable operators and therefore need not acquire franchises. Second, the FCC could preempt local franchising laws to the extent that they unreasonably deny franchises to new entrants.

A. Exempting telcos from cable franchise regulations

Title VI of the Communications Act of 1934 governs cable communications.[62] However, what the average consumer understands simply as "cable TV" is subdivided by the statute into a series of components. The Act applies different regulatory treatment to each of these components. Therefore, how a new service is classified—that is, how it is found to fit within the existing statutory definitions—determines the regulatory obligations that apply. The FCC is effectively the ultimate arbiter of how a new service is classified and thus regulated.[63]

Pay television services are provided by what the statute calls "multichannel video programming distributors" (MVPDs). These include cable television operators, direct broadcast satellite service providers, "wireless cable" providers, and generally any other entity that "makes available for purchase, by subscribers or customers, multiple channels of video programming."[64] Any telco that makes a video offering will be considered an MVPD.[65]

All MVPDs are subjected by the Act to a number of regulations. These include closed captioning mandates,[66] retransmission consent rules,[67] and equal employment opportunity standards[68] among others. However, not all MVPDs are subject to franchising regulations. Only "cable operators," a

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[62] 47 U.S.C. § 521 et seq. (2000).

[63] 47 U.S.C. § 151 (2000). This is doubly true after the Supreme Court held in *Brand X* that an agency has the ultimate interpretative authority over the statute it administers if that statute is ambiguous, even when a court has previously interpreted the same statute. Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 125 S. Ct. 2688 (2005).

[64] 47 U.S.C. § 522(13) (2000).

[65] In a filing arguing that its video offering is not subject to franchise regulation, SBC (now AT&T) nevertheless accepts that it will be subject to regulations that apply to MVPDs. SBC, *The Impact and Legal Propriety of Applying Cable Franchise Regulation to IP-Enabled Video Services*, WC Docket No. 04-36 (Sept. 14, 2005) at 13 (hereinafter "SBC Memo").

[66] 47 C.F.R. § 79.1 (2005).

[67] 47 U.S.C. § 325 (2000).

[68] 47 U.S.C. § 554(h)(1) (2000).

subset of all MVPDs, must acquire a local franchise before they can provide service.[69] They must also pay franchise fees and meet other franchise obligations.[70] Therefore, if the FCC finds that telcos offering video service do not fit the statutory classification of "cable operators," they will not be obligated to acquire a local franchise before they are allowed to provide service.

3. *Are telcos "cable operators"?*

A "cable operator" is defined by the Act as someone who provides "cable service" over a "cable system."[71] Therefore, if a telco does not provide "cable service," or if it does but not over a "cable system," then it will not be considered a "cable operator" and will thus not be subject to franchise regulations under Title VI.

a. *Do telcos provide "cable service"?*

"Cable service" is defined in Title VI as "(A) the *one-way transmission* to subscribers of (1) *video programming*, or (2) *other programming* service, and (B) *subscriber interaction*, if any, which is required for the selection or use of such video programming or other programming service[.]"[72]

The FCC has said that the term "one-way transmission to subscribers" in the definition of cable service reflects the traditional view of cable television wherein all channels of video are broadcast simultaneously to all subscriber households and set-top tuners are used to display only the selected channel on the subscriber's television set.[73] Two-way service, in contrast, is described by the legislative history of the 1984 Cable Act as "the transmission of voice and data traffic, and transactional services such as at-home shopping and banking."[74] The FCC has explained that the purpose of this distinction was to exempt traditional cable service from common carrier regulation, while not necessarily exempting two-way services, such as telephone service, provided

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[69] 47 U.S.C. § 541(b) (2000).

[70] *Id.*

[71] 47 U.S.C. § 522(5) (2000).

[72] 47 U.S.C. § 522(6) (2000) (emphasis added).

[73] Federal Communications Commission, *Inquiry Concerning High Speed Access to the Internet Over Cable and Other Facilities*, *Declaratory Ruling and Notice of Proposed Rulemaking*, GN Docket No. 00-185, 17 FCC Rcd 4798, 4833-34, at ¶ 61 (2002) (hereinafter "Cable Order"). *See also* H.R. REP. NO. 98-934, at 27 (1984), *reprinted in* 1984 U.S.C.C.A.N. 4655, 4664 (hereinafter "1984 House Report").

[74] 1984 House Report at 27, 1984 U.S.C.C.A.N. at 4664.

over cable systems.[75] Therefore, to the extent that the FCC finds that video services offered by telcos are not one-way transmissions, such transmissions will not be "cable service," telcos will in turn not be "cable operators," and franchise regulations will not apply.

There are three ways that telcos might offer video service to subscribers. The first is by offering different tiers of bundled video channels much like cable television providers offer today. The second is by offering a purely on-demand service in which there are no channels as such, and customers select from a menu the video programs they wish to watch, whenever they want to watch them. The last is a combination of the two, where customers have access to traditional channels, such as CNN and ESPN, but can also request programs on demand. Today, many cable operators offer on-demand movies and other programs alongside "live TV" channel broadcasts.

Verizon has begun to offer video services to subscribers in a few municipalities, including Keller, Texas.[76] Its offering includes traditional video channels as well as on-demand content.[77] AT&T (formerly SBC), on the other hand, plans to launch a video service that it claims is purely on-demand.[78] However, what AT&T means by on-demand is that, unlike cable, it will not transmit all channels simultaneously to a subscriber and rely on a set-top box to allow the subscriber to choose which channel to display.[79] Instead, when a customer chooses a channel or an on-demand program, a signal is sent to AT&T and only then is that channel or program transmitted to the subscriber.[80] AT&T's service is point-to-point, not point-to-multipoint. To the subscriber, however, this distinction is invisible.

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[75] Cable Order at ¶ 61. *See* Communications Act § 621(c), 47 U.S.C. § 541(c) (2000) ("Any cable system shall not be subject to regulation as a common carrier or utility by reason of providing any *cable service*.") (emphasis added); 1984 House Report at 41, 1984 U.S.C.C.A.N. at 4678 ("The Committee intends this definition of cable service to mark the boundary between those services provided over a cable system which would be exempted from common carrier regulation under section 621(c) and all other communications services that could be provided over a cable system.")

[76] Phil Harvey, *Verizon Sets TV Precedent*, LIGHT READING, Feb. 2, 2005, *at* http://www.lightreading.com/document.asp?doc_id=67123 (last visited Feb. 7, 2006); *Verizon FiOS TV User Review*, I4U NEWS, Oct. 11, 2005, *at* http://www.i4u.com/article4365.html (last visited Feb. 7, 2006).

[77] *Id.*; Press Release, Verizon, Verizon FiOS TV Is Here! (Sept. 22, 2005) *available at* http://www22.verizon.com/about/community/tx/news/sep_22_2005.html (last visited Feb. 7, 2006).

[78] SBC Memo at 15-16.

[79] SBC Memo at 16.

[80] *Id.*

A video service like Verizon's, which, like cable, transmits many channels simultaneously to subscribers,[81] and also offers on-demand services, likely fits the definition of "one-way transmission." AT&T's proposed service, on the other hand, could arguably be found to fall outside the "one-way transmission" definition. However, the opposite conclusion could be just as reasonable. Once a channel is selected, the transmission is one-way; what arguably makes the transmission two-way is subscriber interaction to select a channel. But what Congress likely understood to be two-way transmissions were highly interactive uses such as telephony or electronic banking.[82] Also, the definition of "cable service" allows for "subscriber interaction, if any, which is required for the selection or use of such video programming or other programming service[.]"[83] That clause implies that a limited amount of interactivity is permitted to accomplish channel selection while still retaining the "one-way transmission" classification.

Assuming that telco video providers do engage in one-way transmission to subscribers, the next question we must ask is if they transmit "video programming" or "other programming" as defined in Title VI. The statute defines "video programming" as "programming provided by, or generally considered comparable to programming provided by, a television broadcast station."[84] To the extent that telco video providers offer channels of network streams, such as MTV or the Discovery Channel, their content will fall within the definition of video programming.

The only way a telco video provider might escape that definition is if it offers on-demand programming exclusively, and does not offer network channels.[85] In that case, such content would arguably not be comparable to a broadcast television station's transmission. Interpreting the statutory definition of

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[81] Vince Vittore, *Verizon uses RF for FiOS TV*, TELEPHONY ONLINE, Sept. 26, 2005, *at* http://telephonyonline.com/fttp/marketing/telecom_verizon_uses_rf/ (last visited Feb. 7, 2006).

[82] *See supra,* note 74 and accompanying text.

[83] 47 U.S.C. § 522(6)(B) (2000).

[84] 47 U.S.C. § 522(20) (2000). The FCC has interpreted this definition to mean "programming comparable to that provided by broadcast television stations in 1984 [the year the Cable Act was enacted]." Federal Communications Commission, *Telephone Company-Cable Television Cross-Ownership Rules, Sections 63.54-63.58*, *Second Report and Order, Recommendation to Congress, and Second Further Notice of Rulemaking*, CC Docket No. 87-266, 7 FCC Rcd 5781 (1992), at ¶ 74 (hereinafter "Video Dialtone Order").

[85] It should be noted that if a telco's is found not to be offering "video programming," then it will not fall within the statutory definition of a "Multichannel video programming distributor" (MVPD). 47 U.S.C. § 522(13) (2000). Consequently, not only will franchising regulations not apply to the telco, but neither will any of the other regulations that apply generally to all MVPDs, which are described in *supra* notes 64-68 and accompanying text.

"video programming" in its "video dialtone" rulemaking in 1992, the FCC stated:

> One of the key characteristics of the programming offered in 1984 by broadcast stations, superstations, cable networks and pay cable was that it was "one-way"—i.e., it provided no opportunity for viewer interaction, manipulation or customization. By contrast, many of the video services that could be provided over a video dialtone network involve a high degree of interactivity that would enable the subscriber to tailor the video images to his or her specific requests. We conclude that Congress intended for video services involving such complex viewer interaction generally to fall outside the scope of "video programming," since they would not be comparable to the programming provided by broadcast stations and others in 1984. We stress, however, that some elements of an interactive video service may be deemed to be "video programming" if those elements can readily be separated from the interactive service and provided as independent video programming comparable to that carried in 1984.[86]

Therefore, the level of interactivity involved is once again definitive. Simple channel selection would likely not rise to the level of interactivity necessary to fall outside the scope of "video programming."[87]

It is possible that even if a telco video provider's content does not fit the definition of video programming, it could nonetheless fit the definition of "other programming service" and still be classified as a cable service. "Other programming service" is defined in the statute as "information that a cable operator makes available to all subscribers generally."[88] However, this definition is unhelpful because it relies on the term "cable operator," which is, after all, what we are ultimately trying to define, and thus makes the definition circular. In addition, the legislative history suggests that what Congress meant by "other programming services" were services "that make non-video information generally available to all subscribers [but] are included as cable services because they are sufficiently like video programming to warrant similar [common carrier] regulatory exemption."[89] The House Report goes on to explain that the key to "other programming services" is that they

[86] Video Dialtone Order at ¶ 75.

[87] In fact, Congress explicitly stated that pay-per-view programming—which is similar to simple channel selection, albeit with an attendant payment—would constitute video programming. 1984 House Report at 43, 1984 U.S.C.C.A.N. at 4680.

[88] 47 U.S.C. § 522(14) (2000).

[89] 1984 House Report at 41, 1984 U.S.C.C.A.N. at 4678.

are made generally available to all subscribers and do not consist of subscriber-specific data.[90] Therefore, as long as the telcos make their programming content available to all their subscribers—even if those subscribers watch the programming asynchronously—their content could reasonably be found to fall within the definition of "other programming services."

A fair interpretation of the statutory definitions leads to the conclusion that telco video, including on-demand services such as AT&T's planned offering, likely constitute the one-way transmission of video programming. Therefore, telco video is likely a "cable service." However, there is enough ambiguity in the definitions that the FCC could reasonably come to the opposite conclusion.[91]

b. Do telcos provide service over a "cable system"?

To be subject to franchise regulation, a telco must not only provide "cable service," but it must also do so over a "cable system." Title VI defines "cable system" as

> a facility, consisting of a set of closed transmission paths and associated signal generation, reception, and control equipment that is designed to provide cable service which *includes video programming* and which is provided to multiple subscribers within a community, but such term does not include . . . (C) a *facility of a common carrier* which is subject, in whole or in part, to the provisions of subchapter II of this chapter, *except* that such facility shall be considered a cable system . . . to the extent such facility is used in the transmission of video programming directly to subscribers, *unless the extent of such use is solely to provide interactive on-demand services*. . . .[92]

The first thing to note about this definition is that a "cable system" must be "designed to provide cable service *which includes video programming*." If this clause means that "cable systems" are only those facilities that provide "cable services" that include "video programming," then "cable system" will not encompass facilities that only include "other programming service." Therefore, the facilities of a telco whose service offering is found to be a "cable service" because it offers "other programming service" but not "video

[90] *Id.*

[91] For example, it is unclear how much interactivity would be necessary to remove telco video out from the "one-way" transmission or "video programming" categories.

[92] 47 U.S.C. § 522(7) (2000) (emphasis added).

programming" will not be considered a "cable system." Consequently, that telco will not be a "cable operator" and will escape franchise regulation.

However, "designed to provide cable service which includes video programming" might instead mean that any facility designed to provide cable service is a cable system, and that video programming is but one of the content types that a cable service might include. Some evidence for this view can be found in the House Report, which states that "[t]he term 'cable system' is not limited to a facility that provides only cable service which includes video programming."[93] This could mean that "cable system" is not limited to a facility that solely provides video programming, but rather encompasses cable service that solely provides other programming service or a mixture of video and other programming.

The FCC could conclude that telcos are not offering video programming and that their networks are therefore not cable systems. However, as noted above, a service would have to have a high degree of interactivity to fit the definition of "other programming," and this makes it unlikely that telco offerings will qualify. Additionally, if a telco offering is found not to be offering video programming, then it will avoid being subject not just to franchise regulations, but all regulations that apply to MVPDs.[94] Nevertheless, there is a second way that a telco might escape classification as a cable system.

The statutory definition of "cable system" includes five exceptions.[95] One of these states that the facilities of common carriers, such as telcos, will be considered cable systems "to the extent such facilit[ies] [are] used in the transmission of video programming directly to subscribers[.]"[96] But it goes on to state that they will not be considered cable systems if "the extent of such use is solely to provide interactive on-demand services[.]"[97] Therefore, a telco whose facilities are subject to common carrier regulation can offer video programming and still avoid classification as a cable system if it offers only an interactive on-demand service.

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93 1984 House Report at 44, 1984 U.S.C.C.A.N. at 4681 (emphasis added).

94 *See supra*, note 85.

95 The FCC recognizes these exceptions. Federal Communications Commission, *Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, Order and Notice of Proposed Rulemaking*, CS Docket No. 96-85, at ¶ 52.

96 47 U.S.C. § 522(7)(C) (2000).

97 47 U.S.C. § 522(7)(C) (2000). This second clause was added by the Telecommunications Act of 1996.

Not surprisingly, the term "interactive on-demand service" is also defined in the statute. It means, "a service providing video programming to subscribers over switched networks on an on-demand, point-to-point basis, but does not include services providing video programming prescheduled by the programming provider."[98] Some telco offerings, such as AT&T's, might qualify under the first part of the definition because they likely provide video programming and they do so "on an on-demand, point-to-point basis," as opposed to a point-to-multipoint basis. The second part of the definition, however, excludes services that provide "video programming prescheduled by the programming provider." To the extent that second clause is interpreted to encompass traditional channels (such as TNT or NBC) that contain "prescheduled" programs, an offering that includes those channels, even if they are offered only on demand and on a point-to-point basis, would not qualify for the "interactive on-demand service" exception to cable system.

However, the "interactive on-demand" exception, along with the definition of that term, was added by the 1996 Telecommunications Act, and there is hardly any legislative history explaining its intent or meaning.[99] Nor has the FCC previously interpreted the meaning of this exception. It would therefore not be unreasonable for the FCC to apply a narrow reading to it. The Commission could determine that the phrase "prescheduled by the programming provider" only refers to non-on-demand services where there is little or no user interactivity. Under such an interpretation, telco video offerings that are exclusively on-demand point-to-point services—even if they include video programming such as traditional cable and broadcast channels—will fall outside the classification of cable system. They would thus not be cable operators and would not face franchise regulation under the Act. This exception to a cable system designation, however, would not cover telco video offerings that are point-to-multipoint, such as Verizon's. In this way, it would not address the franchise problem completely.

c. Conclusions

Telco video services can be relieved from franchise regulation if they are found to be either not a cable service or not a cable system. They can avoid a cable service designation if the FCC finds that they do not offer "one-way" service. However, the statute, legislative history, and FCC precedent

[98] 47 U.S.C. § 522(12) (2000).

[99] The only legislative history is in the House Conference report for the 1996 Act. The total mention is: "Paragraph (2) amends paragraph (7) of section 602 of the Communications Act to clarify that the provision solely of interactive on-demand services over a common carrier facility or the provision of an open video system does not render the facility a cable system and redesignates paragraphs (12) through (19) as (13) through (20), and inserts paragraph (12), defining 'interactive on-demand services.'" H.R. CONF. REP. NO. 104-458, at 179 (1996).

suggests that much more user interactivity than telcos now plan for their video offerings is required to fall outside the scope of "one-way" service.[100] A second way telcos might avoid a cable service designation is if the FCC finds that they do not offer "video programming." This seems politically impracticable because as a result of such a finding they would also not be subject to any Title VI regulation.[101] Additionally, even if the telcos' offerings are found to be so unlike broadcast television that they are not video programming, they could still be considered "other programming service," and kept within the cable service classification.

Even if a telco's video is a cable service, it can still avoid franchise regulation if it is not provided over a cable system. Telcos can avoid a cable system designation if 1) they were found not to be offering "video programming," and 2) the FCC finds that cable systems only include facilities that provide video programming. However, the legislative history suggests that Congress did not intend to limit cable systems to only those facilities that carry video programming. A second way telcos might avoid a cable system designation—and probably the most feasible way telcos could escape franchise regulation—is via the "interactive on-demand exception." However, this exception would only apply to telcos that offer point-to-point service.

4. *Video programming by telcos*

Despite the above analysis, some have suggested that, under the statute, telcos can only offer video services in a few enumerated ways.[102] Part V of Title VI is entitled, "Video Programming Services Provided by Telephone Companies." It states in Section 651,

> To the extent that a common carrier is providing video programming to its subscribers in any manner other than [via radio under Title III or as a common carrier under Title II] . . ., such carrier shall be subject to the requirements of [Title VI],

[100] Additionally, the point-to-multipoint technology that some telcos plan to use, which is similar to existing cable TV technology, might preclude a classification other than one-way. This could lead to a situation in which some telcos are exempted from franchise regulations while others are not.

[101] *See supra*, note 85. SBC (AT&T), for one, has conceded that it will be subject to regulations that apply to MVPDs even though it contends that its video offering is not subject to franchise regulation. SBC Memo at 13.

[102] NCTA, *Applicability of Title VI to Telco Provision of Video Over IP*, WC Docket No. 04-36 (July 29, 2005) at 15 ("The 1996 Act offered phone companies four ways in which to enter the cable business. Telcos may provide transmission of video programming [as a common carrier, via radio, or via OVS.] . . . Finally, the statute made clear, by adding Section 651(a)(3)(A) to the Communications Act, . . . that the telcos' only other option was to provide video programming as a cable operator subject to Title VI.") (hereinafter "NCTA Memo").

> unless such programming is provided by means of an open video system[.][103]

The claim is that, putting aside radio and common carriage delivery, which the telcos do not plan to employ, the only two ways they may offer video is as a cable operator or as an open video system (OVS).[104] The FCC expressed a similar point of view when it recently stated,

> The Communications Act provides new entrants four options for entry into the MVPD market. They can provide video programming to subscribers via radio communication, a cable system or an open video system, or they can provide transmission of video programming on a common carrier basis. Any new entrant opting to offer "cable service" as a "cable operator" becomes subject to the requirements of Title VI [and its franchising regulations].[105]

It should first be noted that Section 651 is only operable "[t]o the extent that a common carrier is providing video programming." If, as discussed above, the FCC finds that telco offerings are not "video programming" as defined in the Act, then Section 652 does not apply. Secondly, even if a telco is offering video programming, the binary choice posed by Section 651 is not between OVS and "cable operator" status, but between OVS and "being subject to the requirements of [Title VI]."[106] As we have seen, if telcos offer video programming, they will be subject to the Title VI regulations that apply to all MVPDs. It does not follow, however, that simply because Title VI applies to telcos that they must necessarily be cable operators. For one thing, they might avoid cable operator status by not qualifying as a cable system thanks to the "interactive on-demand" exception. Therefore, nothing in Section 651 obliges the FCC to regulate telcos that provide video programming as cable operators subject to franchise regulations.

B. FCC preemption of local franchising rules

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[103] 47 U.S.C. § 571(a)(3)(A) (2000).

[104] NCTA Memo at 6-7. An open video system (OVS) is a hybrid classification, created by the 1996 Telecom Act and meant to replace "video dialtone,' which combines elements of common carrier and cable regulation. *See* Kimberly Auerbach, *OVS: A Platform Worth Investing In?*, 5-Fall MEDIA LAW & POL'Y 15 (1996).

[105] Federal Communications Commission, *Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984 as amended by the Cable Television Consumer Protection and Competition Act of 1992*, MB Docket No. 05-311 (released Nov. 18, 2005), at ¶ 2 (hereinafter "Franchising NPRM").

[106] 47 U.S.C. § 571(a)(3)(A) (2000). The legislative history shows no intent of creating a binary choice between OVS and cable operator. H.R. CONF. REP. NO. 104-458, at 172 (1996).

The second way the FCC could address the problem of franchising is by preempting local franchising laws to the extent that they unreasonably deny franchises to new entrants. Section 621 of the Communications Act prohibits operators from offering cable service without a franchise.[107] It also gives local franchising authorities (LFAs) the power to grant those franchises.[108] However, the Act goes on to state in Section 621(a)(1) that an LFA "may not grant an exclusive franchise and may not unreasonably refuse to award an additional competitive franchise."[109] The only remedy provided by the Act for parties who feel they have been unreasonably denied a franchise is review by a court.[110]

The FCC recently began a rulemaking that, if adopted, would allow it to preempt "any law or regulation of a State or LFA that causes an unreasonable refusal to award a competitive franchise in contravention of section 621(a)."[111] In effect, the FCC would strike down local laws that would, in its judgment, inevitably result in unreasonable denial of franchises. Because the salient economic justifications for franchising are (1) the regulation of natural monopoly, (2) the protection of "specialized capital," or (3) the management of the public rights-of-way, any local franchising laws or regulations that are inconsistent with these goals, or with some other statutorily granted power, would be good candidates for preemption.

1. *The FCC's preemption authority*

The FCC has several sources of authority to preempt local franchising rules that hinder competition. First, Congress has explicitly delegated preemption power to the FCC in Section 636(c), which states that "any provision of law of any State, political subdivision, or agency thereof, or franchising authority, or any provision of any franchise granted by such authority, which is inconsistent with this Act shall be deemed to be preempted and superseded."[112] Therefore, to the extent that local franchising laws and regulations act to "unreasonably refuse" competitive franchises,[113] they are preempted by Section 636(c). The FCC need only determine which local

[107] 47 U.S.C. § 541 (2000).

[108] *Id.*

[109] 47 U.S.C. § 541(a)(1) (2000).

[110] 47 U.S.C. § 541(a)(1) & § 555 (2000). It should be noted that simply because the Act makes a remedy available to would-be franchisors, it does not follow that Commission enforcement of the section is precluded. *See infra,* note 122 and accompanying text.

[111] Franchising NPRM at ¶ 15.

[112] 47 U.S.C. § 556(c) (2000).

[113] 47 U.S.C. § 541(a)(1) (2000).

franchising rules are offending and preempt them subject to its Section 1 charge to "execute and enforce the provisions of [the Act]."[114]

Secondly, even if the Commission did not have an express delegation of preemption power, the Supreme Court has held that "'a federal agency acting within the scope of its congressionally delegated authority may pre-empt state regulation' and hence render unenforceable state or local laws that are otherwise not inconsistent with federal law."[115] As the Supreme Court explained last year in its *Brand X* decision, "Congress has delegated to the Commission the authority to 'execute and enforce' the Communications Act, § 151, and to 'prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions' of the Act, § 201(b). These provisions give the Commission the authority to promulgate binding legal rules[.]"[116] Additionally, the FCC has specifically been found to have authority to interpret Section 621 and regulate pursuant to it.[117]

In preempting local rules that result in unreasonable denials of competitive franchises, the FCC would be acting consistent with the Act and within its delegated authority. The 1984 Cable Act created Section 621, which then read, "A franchising authority may award, in accordance with the provisions of this title, 1 or more franchises within its jurisdiction."[118] The 1992 Cable Act amended the section by adding the limitation: "except that a franchising authority may not grant an exclusive franchise and may not unreasonably refuse to award an additional competitive franchise."[119] The legislative history explains that the purpose of this preemption of local prerogative was to promote competition among two or more cable systems in local franchise areas.[120] If the FCC finds that localities have enacted laws or rules that

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[114] 47 U.S.C. § 151 (2000).

[115] City of New York v. FCC, 486 U.S. 57, 63-64 (1988), quoting Louisiana Public Service Comm'n v. FCC, 476 U.S. 355, 369 (1986). The Court concluded that in cases involving preemption by federal regulation, "a 'narrow focus on Congress' intent to supersede state law [is] misdirected,' for '[a] preemptive regulation's force does not depend on express congressional authorization to displace state law.'" *Id.* at 64 (quoting Fidelity Federal Sav. and Loan Ass'n v. de la Cuesta, 458 U.S. 141, 154 (1982). *See also* Capital Cities v. Crisp, 467 U.S. 691 (1984) (holding that regulations have no less preemptive effect than federal statutes when Congress has authorized the regulator to exercise its discretion).

[116] Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 125 S. Ct. 2688, 2699 (2005) (citations omitted).

[117] City of Chicago v. FCC, 199 F.3d 424 (7th Cir. 1999) (holding that FCC has regulatory the authority to interpret Section 621 and regulate subject to it).

[118] Cable Communications Policy Act of 1984, Pub. L. No. 98-549, 98 Stat. 2779.

[119] 47 U.S.C. § 541(a)(1) (2000).

[120] S. REP. NO. 102-92, at 14 (1991) ("[I]t is clear that there are benefits from competition between two cable systems. Thus, the Committee believes that local franchising authorities

result in the unreasonable denial of competitive franchises, then it may preempt those laws in order to give effect to Title VI's purpose, stated in Section 601, to "promote competition in cable communications and minimize unnecessary regulation that would impose an undue economic burden on cable systems."[121]

Unlike applicants who must wait to be "denied [a franchise] by a final decision" of the LFA before they can appeal in court, the FCC need not wait for such a final decision before it can enforce the prohibition on unreasonable refusals. The "final decision" language in Section 621(a)(1) applies only to applicants, not the Commission. On the contrary, the Commission is charged with executing and enforcing the provisions of the Act.[122] That includes Section 621(a)(1)'s provision that LFAs "may not unreasonably refuse to award an additional competitive franchise."[123] *Refusing to award* a franchise is not the same thing as *denying* a franchise. The latter implies an affirmative act turning down the request, while the former can be achieved by omission. An LFA can fail to make a final decision and still be said to have refused to award a franchise if it simply never makes a decision or takes so long to do so that it becomes a moot point. Additionally, an LFA can be said to have refused to award a franchise if the terms it sets out are so onerous that a new entrant could not possibly meet them. Therefore, the Commission has the authority to enforce Section 621(a)(1) by preempting state and local policies and practices that result in *de facto* refusals to award competitive franchises.

Another source of FCC preemption authority can be found in Section 703 of the 1996 Telecommunications Act, which mandates the FCC and the states to "encourage the deployment . . . of advanced telecommunications capability to all Americans . . . by utilizing, . . . regulatory forbearance, measures that promote competition in the local telecommunications market, or other regulating methods that remove barriers to infrastructure investment."[124] As Levin and Meisel explain, "[n]o discussion of cable television and telecommunications can take place without reference to broadband" because both cable and telephone companies are converging in their plans to offer similar and competing broadband services.[125] To the extent that current

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should be encouraged to award second franchises. Accordingly, S. 12 as reported, prohibits local franchising authorities from unreasonably refusing to grant second franchises.")

[121] 47 U.S.C. § 521(6) (2000).

[122] 47 U.S.C. § 151 (2000).

[123] 47 U.S.C. § 541(a)(1) (2000).

[124] Telecommunications Act of 1996, Pub. L. No. 104-104, § 706, 110 Stat. 153 (codified at 47 U.S.C. § 157 note).

[125] Levin & Meisel, *supra* note 32, at 519-20.

franchising policies and practices are retarding the deployment of advanced telecommunications service, the FCC has the authority to preempt those policies and practices. Additionally, competition is the purpose of Title VI as stated explicitly in Section 601, and given effect by Section 621(a)(1). Therefore, policies and practices that act as anticompetitive barriers to entry, and that lack countervailing effects to offset the harm of lost competition, may be preempted in order to fulfill that purpose.

The FCC also has the authority to adopt rules to implement Section 621(a)(1). As noted above, Section 1 of the Act gives the Commission authority "to execute and enforce the provisions" of the Act, and according to the Supreme Court, this includes the authority to "promulgate binding legal rules[.]"[126] Section 4 of the Act further states that "[t]he Commission may perform any and all acts, make such rules and regulations, and issue such orders, not inconsistent with this Act, as may be necessary in the execution of its functions."[127]

2. *Limitations to FCC authority*

The FCC may not preempt local laws or rules explicitly sanctioned by the Act or consistent with the express provisions of the Act.[128] For example, the Act gives LFAs the power to require as part of the franchising process that a certain amount of a cable operator's channel capacity be dedicated to public, educational, and government (PEG) use.[129] Therefore, the FCC may not preempt local policies that require cable operators to dedicate channel capacity to PEG channels, even if such a requirement results in the denial of a competitive franchise. Other nonprice concessions that the Act allows LFAs to require as conditions for franchising include facilities and financial support for the operation of PEG channels,[130] the creation and maintenance of an institutional network,[131] and assurances that the would-be franchisee is financially and technically qualified to operate a cable system.[132]

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[126] Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 125 S. Ct. 2688, 2699 (2005).

[127] 47 U.S.C. § 154(i) (2000).

[128] 47 U.S.C. § 556(a) (2000) ("Nothing in this title shall be construed to affect any authority of any [locality] regarding matters of public health, safety, and welfare, to the extent consistent with the express provisions of this title.").

[129] 47 U.S.C. § 531 (2000). LFAs must nevertheless establish procedures under which the cable operator may utilize unused PEG channel capacity for other services. 47 U.S.C. § 531(d)(1).

[130] 47 U.S.C. § 541(a)(4)(B) (2000).

[131] 47 U.S.C. § 541(b)(3)(D) (2000). Zupan has reported that institutional networks go largely unused and quotes on cable operator who describes them as "just an expensive toy for the local politicians that was necessary to win the franchise." Zupan, *supra* note 39, at 405.

[132] 47 U.S.C. § 541(a)(4)(C) (2000).

However, if the statutory power to impose certain conditions on franchises is exercised in such a way that results in the *unreasonable* denial of franchises, then the Commission may preempt consistent with the Act. For example, in accordance with its statutory power to require channel capacity for PEG channels, an LFA might condition a franchise on a cable system dedicating 50 percent of its capacity to PEG channels. While the Act does not cap the number of PEG channels an LFA may require, some amounts will no doubt rise to the level of unreasonable and will act as a *de facto* unreasonable denial of a franchise in contravention of Section 621(a)(1). Using its authority to interpret Section 621, the FCC may determine what qualifies as unreasonable.[133]

Legislative history lends support to this interpretation. Examples of reasonable grounds on which a competitive franchise could be denied were considered and excluded from the 1992 Cable Act. The House version of Section 621 included a list of examples of reasonable bases on which a franchise could be denied,[134] but they were removed from the final bill. The list included "inadequate assurance that the cable operator will provide adequate [PEG] channel capacity, facilities, or financial support," "inadequate assurance that the cable operator will, within a reasonable period of time, provide universal service throughout the entire franchise area," and "inadequate assurance that the cable operator has the financial, technical, or legal qualifications to provide cable service."[135] The Senate version of Section 621 included the provision that "refusal to award a second franchise on the grounds of technical infeasibility shall be deemed not to be unreasonable."[136] That clause was also excluded from the final Act. Because specific examples of reasonable grounds on which a franchise could be denied were considered and omitted by Congress, there is reason to believe that its final intent was to leave reasonableness up to agency and court interpretation.

3. *What qualifies as an "unreasonable refusal"?*

At least broadly, it is not difficult to identify the types of LFA policies and practices that would result in *de facto* refusals to grant competitive franchises. As we saw earlier, Congress chose not to explain what would

[133] The FCC has authority to interpret Section 621. City of Chicago v. FCC, 199 F.3d 424 (7th Cir. 1999) (holding that FCC has regulatory the authority to interpret Section 621 and regulate subject to it). *See also* National Cable Television Ass'n v. FCC, 33 F.3d 66 (D.C. Cir. 1994) (upholding an FCC interpretation of Section 621(b)(1)).

[134] H.R. REP. NO. 102-628, at 9 (1992).

[135] *Id.*

[136] S. REP. NO. 102-92, at 112 (1991).

qualify as an unreasonable refusal of a franchise. We do know, however, that a franchise refusal that would have the effect of subverting Title VI's stated purpose to "promote competition in cable communications and minimize unnecessary regulation that would impose an undue economic burden on cable systems"[137] would necessarily be unreasonable.

Given the pro-competitive goals of the Communications Act, and Title VI specifically, refusal of a competitive franchise would be reasonable only if it was justified as a step taken to enhance consumer welfare by limiting entry. As Part I explained, the only plausible rationales for limiting entry are regulating unsustainable natural monopolies and facilitating investment in "specialized capital." However, as we have seen, two decades of research and historical data show conclusively that competition consistently leads to lower prices and improved quality. It would therefore be unreasonable to refuse a competitive franchise on those grounds. Additionally, to effectively manage the public rights-of-way a locality does not need to limit entry, so that refusal on that ground would be unreasonable as well. All other rationales for limiting entry serve only to protect an incumbent from competition and are thus unreasonable.

a. Rights-of-way

Local control of the public rights-of-way has traditionally been the source of authority that has allowed LFAs to control entry into the cable market through franchising.[138] Today, the source of LFA franchising power is the express grant of that authority by Title VI of the Communications Act.[139] The Act stipulates that an award of a franchise "shall be construed to authorize the construction of a cable system over public rights of way[.]"[140] Therefore, it would be reasonable to refuse a franchise on rights-of-way grounds only when the public rights-of-way could not support construction of a second cable system. That, however, is not a credible concern.

First, in the rare case that underground and aerial utility ducts are at capacity, they can always be expanded. As Hazlett and Ford note, "The [only] policy question is: who pays?"[141] The answer to crowding is not to limit entry,

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[137] 47 U.S.C. § 521(6) (2000).

[138] Hazlett, *supra* note 12, at __.

[139] 47 U.S.C. § 621(a)(1) (2000). *See supra*, note 8.

[140] 47 U.S.C. § 621(a)(2) (2000).

[141] Thomas W. Hazlett & George S. Ford, *The Fallacy of Regulatory Symmetry: An Economic Analysis of the 'Level Playing Field' in Cable TV Franchising Statutes*, 3 BUS. & POL. 21, 30 (2001).

but to allocate space through a congestion price mechanism. Second, management of public inconvenience caused by construction cannot reasonably require the denial of a franchise. Today, utility companies, including telcos, are subject to regulations of general applicability controlling construction on public ways. Through such regulations utilities are made to internalize the costs they impose on the public, and localities are allowed to recover the cost of policing compliance and making repairs.[142] Telcos already have access to the public rights-of-way that they would use to provide video services and, in fact, they already provide other broadband services over these same facilities. Therefore, refusal of a franchise on rights-of-way grounds would be unreasonable.[143]

b. Unsustainable natural monopoly and "specialized capital"

The history of overbuilding in the cable industry gives lie to the notion that cable television is a natural monopoly. So does intermodal competition from DBS. As Hazlett points out, "while overbuilding an existing cable system can lower the profitability of the incumbent operator, it unambiguously improves the position of consumers who face prices determined not by historical costs, but by the interplay of supply and demand."[144] The economics literature shows that franchising has not been employed to remedy unsustainable natural monopoly or a "specialized capital" problem, but instead has entrenched local cable monopolies.[145] Posner has explained that, through franchising, local authorities seek to obtain the monopoly rents for themselves.[146] This is apparent in the nonprice concessions LFAs extract from franchisees that have nothing to do with addressing any such problems.

Competition in the cable industry is the clear policy of both Congress and the FCC. Therefore, unless an LFA can show that the cable system in its jurisdiction is an unsustainable natural monopoly or faces a "specialized capital" problem, it cannot reasonably refuse a second franchise on those

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[142] Gardner F. Gillespie, *Rights-of-Way Redux: Municipal Fees on Telecommunications Companies and Cable Operators*, 107 DICK. L. REV. 209, 215-16 (2002).

[143] It should be noted that the Act provides for the regulation of access to, and rates for, rights-of-way owned by utilities. 47 U.S.C. § 224 (2000). To the extent that franchise fees are used to recover the costs of using rights-of-way, they would only be justified to recover the costs imposed on the locality.

[144] Thomas Hazlett, *Duopolistic Competition in Cable Television: Implications for Public Policy*, 7 YALE J. ON REG. 65, 69 (1990).

[145] *See* Section II.B, *supra*.

[146] Richard A. Posner, *The Appropriate Scope of Regulation in the Cable Television Industry*, 3 BELL J. OF ECON. & MGMT. SCIENCE 98, 113 (1972).

grounds. Baumol et al. explain that while preventing entry is one way to address an unsustainable monopoly problem,

> [O]ne must proceed with caution. As long as any doubt remains about the unavailability of sustainable solutions, one must hesitate before bowing to the pressures for the encouragement of barriers to entry. It is understandable and natural for the incumbent firms in an industry who are fearful of enhanced competitive pressures to seek the erection or toleration of protective umbrellas against entry. But those who have the task of protecting the interests of society must resist such demands until the evidence for them is all but incontrovertible. We have seen again and again the sorts of benefits that unrestricted freedom of entry can bring. It is dangerous to risk those benefits on the basis of imperfect evidence indicating that, in a particular case, the market mechanism is likely to function badly.[147]

While it is theoretically possible that an LFA could reasonably refuse a second franchise in order to address a monopoly concern, in practice the rationale is very limited—especially without rate regulation. Historical evidence and academic research show that it is only in the rare case, if ever, that preventing the entry of a competitive cable system would increase consumer welfare. As a result, the default bias should be to doubt the reasonableness of franchise refusals in the absence of great evidence to the contrary.

c. "Level playing field" laws and other barriers to entry

Given Congress's and the Commission's paramount goals of encouraging competition and broadband deployment, all LFA practices and policies that produce barriers to entry should be preempted because they result in *de facto* unreasonable franchise refusals. Many state "level playing field" (LPF) laws are a case in point. They were enacted to ensure regulatory parity between incumbents and new entrants in the cable market by imposing on new cable systems franchise terms at least as burdensome as those shouldered by the incumbent. However, these laws have no other effect than to protect incumbents from competition. As Hazlett and Ford have shown, "rules that ostensibly mandate fairness can create barriers to entry."[148]

LPF laws create *de facto* franchise refusal in several ways. First, LPF laws often require new entrants to match the capital expenditures of incumbents,

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[147] WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE, 472-73 (1982).

[148] Hazlett & Ford, *supra* note 141 at 22.

with the result that "incumbents and franchise authorities can force entrants to incur sunk costs considerably in excess of what free market conditions would imply."[149] This means that while a second cable operator will have to make the same unrecoverable investment previously made by the incumbent, it will not have the benefit a monopoly over which to amortize it. Because the new system will have to compete against the incumbent, it can expect revenue from fewer subscribers and at lower rates than the incumbent previously enjoyed. In addition, capital expenditure requirements ignore the possibility that new technology may allow some new entrants to build their systems at a lower inflation-adjusted cost than the incumbent. Would-be new entrants will therefore often find the large up front investment required by LPF laws to be a prohibitive barrier to entry.[150]

Another way that LPF laws present a barrier to entry is by requiring that competitors match the entire area served by the incumbent. Such an obligation prevents new entrants from competing in just a subset of the jurisdiction.[151] This keeps out competitors that might find it cost-effective to compete only partially with the incumbent, or to phase in its service by serving the most lucrative customers first. By foreclosing competition, the obligation precludes subscribers in the potentially competitive areas from enjoying lower rates.

A common justification for requiring new entrants to serve all markets served by an incumbent firm is that "cream-skimming" in the most lucrative markets would erode the profits that subsidize prices in less lucrative markets. The less lucrative markets may be higher cost, or they may consist of consumers who buy only a basic service package. According to this theory, if the new entrant takes the "cream," the incumbent will have to raise prices to its remaining customers, or perhaps even discontinue service to the unprofitable customers.

Whatever the merits of the cream-skimming argument in theory, there are several practical reasons that it is not applicable to contemporary cable markets.

First, the cream-skimming theory requires that some customers pay prices that are below the incremental cost of serving them. These are the customers

[149] Hazlett & Ford, *supra* note 141 at 25.

[150] *Id.*

[151] Although an LFA may require it, there is nothing in Title VI that requires a new entrant to serve an entire jurisdiction. For example, Texas's statewide franchising system allows for "service area footprint[s]" smaller than the municipality in which they are located. TEX. UTIL. CODE ANN. § 66.003(b)(4) (West 2005).

in danger of paying higher prices or losing service if the incumbent loses some of its profits from the more lucrative customers. It is by no means clear, however, that cable companies currently sell service to any subscribers at prices that fail to cover the incremental costs of serving those subscribers. As long as prices cover the incremental costs of serving a subscriber or a group of subscribers, they make a contribution to covering the fixed costs of the cable system. These customers may be *less* profitable than other customers, but they are not *un*profitable. As a result, there is no reason for the cable company to stop serving them just because it loses some of its more profitable customers. Indeed, if the less profitable customers are willing to pay a price that covers the incremental cost of serving them, then there is no reason that new entrants would not also eventually extend service to them, and competition would likely lower their cable rates too.

Second, the theory that the incumbent deprived of the "cream" will raise prices to other customers makes sense only if regulation effectively constrains the prices these customers pay. An incumbent unconstrained by regulation will charge whatever price it believes the market will bear (taking into account concerns such as its reputation for fair dealing and the possibility that higher price might attract competition). Such an incumbent is already charging its customers the most profitable price. A cable incumbent that lost customers to competition and then tried to increase prices on remaining customers would see its profits fall even further. Given the extensive evidence that cable rate regulation has little effect on cable rates, it is unlikely that cable companies are using profits from lucrative markets to subsidize the prices paid by customers in less profitable markets. Therefore, no consumers are harmed if new competitors are permitted to serve only part of the incumbent cable company's customers. Because noncompetitive portions of the jurisdiction will not see higher rates as a result of competition elsewhere, there is no reasonable justification for forcing new competitors to serve the incumbent's entire territory.

New entrants are also sometimes required to *quickly* serve the entire area that an incumbent has built out over many years—and without the benefit of a monopoly position.[152] This can serve as a barrier to entry because it reduces the time a new entrant has to become profitable. However, Title VI requires that franchise authorities allow new entrants "a reasonable period of time to become capable of providing cable service to all households in the franchise area."[153] The legislative history of this provision states that its purpose is to

[152] It should be noted that such a requirement places an onerous obligation on the new entrant that the incumbent never faced, giving lie to the idea that "level playing field" laws create parity.

[153] 47 U.S.C. § 541(a)(4)(A) (2000).

ensure that Section 621(a)(1)'s prohibition on unreasonable refusals of competitive franchises not be thwarted.[154] Therefore, to the extent that LPF laws and LFA policies mandate build-out schedules that are unreasonable and serve as barriers to competitive entry, they frustrate the Act's goal of competition as well as its clear directive to grant competitors time to deploy their services.

Another local practice that raises a competitor's cost of entry is long delay by LFAs in approving a second franchise.[155] Delays allow the incumbent to prepare itself for aggressive and targeted competition based on what it has learned of the new competitor's plans from the public franchise proceedings.[156] They also make it difficult for competitors to secure capital investment, programming or subscribers. While certainly not codified anywhere, delays are a feature of LPF laws, which often require LFAs to duly consider a laundry list of factors and conduct in-depth studies before a competitive franchise can be granted. In some cases entrepreneurial firms have had to abandon their quest for a competitive franchise after years of delays. Because interminable delays are barriers to entry, they can amount to *de facto* unreasonable refusals.

Finally, nonprice concessions demanded by LFAs are what Posner has termed taxation by regulation.[157] By threatening to withhold a franchise, local authorities can extract an in-kind tax from prospective cable operators. Nonprice concessions can serve as anti-competitive barriers to entry not only because they can be individually onerous in each locality, but because competitors whose successful business plan depends on rolling out service regionally or nationally will have to negotiate and deliver thousands of such concessions.[158] Nevertheless, Title VI expressly permits some of these types of concessions if they are related to the provision of PEG channels or the

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[154] S. REP. NO. 102-92, at 91 (1991). The report goes on to state, "The provision requires local franchising authorities to grant the second or third cable system in a community sufficient time actually to construct its system and provide service. For purposes of this section, a reasonable period of time would include a period of time comparable to that taken for the incumbent cable operator to construct its cable system for a comparably sized franchise area." *Id.*

[155] The GAO has reported that delays have caused some potential entrants to "withdraw their applications and seek more receptive markets." GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 13, at 21.

[156] Thomas W. Hazlett, *Predation in Local Cable TV Markets*, 40 ANTITRUST BULL. 609, 616-17 (1995).

[157] Richard A. Posner, *Taxation by Regulation*, 2 BELL J. OF ECON. & MGT. SCIENCE 22 (1971).

[158] SBC Memo at 9 (explaining that developing region-wide networks are necessary to achieve economies of scale).

establishment or operation of a cable system.[159] However, many requested nonprice concessions seem to be of dubious authority and likely serve only as barriers to entry. As the *Wall Street Journal* recently reported,

> Budget-strapped local officials, who have the final say over granting cable-TV-service franchises, are greeting [Verizon] with expensive and detailed demands. In New York State, Verizon faces requests for seed money for wildflowers and a video hookup for Christmas celebrations. Arlington County, Va., wants fiber strung to all its traffic lights so it can remotely monitor traffic flow. Holliston, Mass., is seeking free television for every house of worship and a 10% video discount for all senior citizens. Others want high-speed Internet for sewage facilities and junk yards, flower baskets for light poles, cameras mounted on stop lights and Internet connections for poor elementary students.[160]

The legislative history of Title VI shows that Section 624, in which LFAs find their authority to require nonprice concessions unrelated to PEG channels, "is intended to provide procedures for and impose limitations on a franchising authority regarding the establishment of requirements related to services, facility, and equipment provided by a cable operator."[161] It goes on to say that an LFA "cannot enforce or impose requirements for services, facilities or equipment which are not related to the operation of a cable system."[162] Therefore, nonprice concessions extracted by LFAs that are not directly related to the establishment or operation of a cable system are not permitted by the Act and certainly contribute to unreasonable refusals of franchises.

4. *The FCC should issue rules preempting local barriers to entry*

As explained above, the FCC has the authority to adopt rules to implement Section 621(a)(1), and it should exercise that authority. By clarifying what state and LFA policies result in *de facto* unreasonable franchise refusals it can give effect to Congress's intent to prohibit such practices. It should also identify local practices that not only result in unreasonable franchise refusals, but are also expressly forbidden by Title VI.

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[159] LFAs have the authority to require "services, facilities, or equipment" related to use of PEG channel capacity. 47 U.S.C. §§ 531(c) & 541(A)(4) (2000). This allows LFAs to require in-kind benefits such as cameras, studios, and other production facilities. LFAs also have the authority to require facilities and equipment "to the extent related to the establishment or operation of a cable system[.]" 47 U.S.C. § 544(b) (2000).

[160] Dionne Searcey, *As Verizon Enters Cable Business, It Faces Local Static; Telecom Giant Gets Demands As It Negotiates TV Deals*, WALL ST. J., Oct. 28, 2005, at A1.

[161] 1984 House Report at 68.

[162] *Id.*

Only by issuing rules—as opposed to simply nonbinding guidelines—can the Commission ensure that Section 621(a)(1) is enforced, and enforced consistently. If the Commission were merely to issue guidelines, nothing much would change. Dissatisfied would-be franchisees would still have to wait for a final LFA decision—perhaps after long delays—before they could litigate a refusal. Additionally, guidelines alone would not address policies that discourage potential new entrants from ever attempting to seek a franchise.

Because unreasonable delays in awarding a franchise can amount to a *de facto* unreasonable refusal, the Commission should set the maximum amount of time an LFA may take to make a decision after a franchise application is filed. While the appropriate amount of time to be set should be studied carefully, it ought to be noted that a GAO study on wireline competition reports that LFAs receptive to competition have issued franchises in 120 days.[163] Similarly, Title VI requires LFAs to decide within 120 days whether to approve the sale or transfer of a cable system.[164]

If a final decision is not reached within the allotted time, the franchise should be deemed granted on a set of default terms. These default terms should also be the subject of close study, but two possibilities suggest themselves. First, default terms for a new franchise could be the same terms as those of the incumbent, but only as they apply to the franchise fee and PEG channel capacity. Alternatively, default terms could simply be set as the maximum franchise fee of five percent and a predefined PEG channel capacity.[165]

If it refuses to award a competitive franchise, an LFA should be required to explain in writing why its refusal is not unreasonable.[166] It is important that LFAs be required to provide not just theoretical or anecdotal support for their refusal, but systematic empirical proof to show why entry should be restricted. Former FTC Chairman Tim Muris has explained the vital need for empirical evidence in FTC rulemakings, and the same logic applies here,

[163] GOVERNMENT ACCOUNTABILITY OFFICE, *supra*, note 13 at 20-21.

[164] 47 U.S.C. § 541 (2000).

[165] For example, Texas's statewide franchising law requires franchisees to provide "(1) up to three PEG channels for a municipality with a population of at least 50,000; and (2) up to two PEG channels for a municipality with a population of less than 50,000." TEX. UTIL. CODE ANN. § 66.009(c) (West 2005).

[166] Today, federal law requires local zoning authority decisions to deny placement of mobile phone towers and other facilities "shall be in writing and supported by substantial evidence contained in a written record." 47 U.S.C. § 332(b)(7)(B)(iii) (2000).

> Theories alone are not enough, [] for creative theoreticians can fashion a convincing rationale for nearly any scheme. Thus, a proposal should not become a rule until systematic evidence has been collected to test its factual premises. Anecdotes, the commission's own expertise, and the testimony of experts can rarely, if ever, provide the necessary confirmation. Such evidence may be consistent with the theory, but cannot test it. And an untested theory should not be imposed on society at large.[167]

Given that competition is at the heart of Title VI, that the purpose of Section 621(a)(1) is to promote competitive entry in the video market, and that historical data and academic research have repeatedly shown that there is no plausible economic justification for restricting entry into local video markets—except to create monopoly—a high standard of proof is warranted.

The Commission should issue a definition of reasonableness that excludes monopoly, "special capital," and rights-of-way rationales unless they can be shown conclusively and empirically by the LFA. If an LFA wished to cite unsustainable natural monopoly as a reason for refusing a franchise, it should have to prove that its jurisdiction is subject to such conditions. If an LFA were to cite rights-of-way concerns as a reason for denying a franchise, it should have to show why local ordinances regulating the use and occupation of public ways would not suffice to address those concerns. Additionally, if a franchise applicant already has access to the rights-of-way, that rationale should be unavailable to the LFA.[168]

A potential entrant that is nevertheless refused a competitive franchise would still have the option, per statute, to appeal the decision in court.[169] If the Commission adopts rules enforcing Section 621(a)(1), however, a court will be able to gauge an LFA's actions against the FCC interpretation of "reasonableness" in that section. Also, if the time an LFA may take in rendering franchise decisions is capped, appealing a "final decision" as the statute requires will become a much more practicable option for potential new entrants that are refused a franchise.

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[167] Timothy J. Muris, *Rules Without Reason: The Case of the FTC*, AEI J. ON GOV. & SOC'Y REG. 20-26 (Sept./Oct. 1982).

[168] As Copple has pointed out, courts in the 1960s that considered the question of whether telcos had to acquire a franchise before they could offer cable service "uniformly held that because the telephone companies had already been granted a franchise (either by state or local authorities) to erect utility poles and string wire, the transmission of cable signals did not constitute an additional use of the public ways requiring a separate franchise." Robert F. Copple, *Cable Television and the Allocation of Regulatory Power: A Study of Government Demarcation and Roles*, 44 FED. COMM. L.J. 1, 48 (1991).

[169] 47 U.S.C §§ 541(a)(1) & 555 (2000).

State "level playing field" laws serve no purpose other than to erect barriers to entry that protect incumbents from competition. As a result, they are in contravention of Title VI's purpose to "promote competition in cable communications[.]"[170] Also, as shown above, the roadblocks posed by LPF laws result in *de facto* franchise refusals that are unreasonable because they limit competition without producing any offsetting increase in consumer welfare. The aspects of these laws discussed above should therefore be preempted by the FCC as inconsistent with the spirit and letter of Title VI.

Section 621(a)(4)(A) requires that LFAs give a new franchisee "a reasonable period of time" to build out its system.[171] The FCC should define what is reasonable in this context as well. One measure of reasonableness is the time the incumbent took to complete the same buildout. However, in setting guidelines for that comparison, the FCC should take the lead of courts that have interpreted the parity requirements of "level playing field" laws. Courts that have looked at the issue have uniformly held that a reasonable buildout time for a new cable system:[172]

- should be judged by looking at the buildout requirement in the incumbent's original franchise—when the incumbent's situation more closely resembled the entrant's current situation—not its renewal franchise.

- should be based on the actual time that the incumbent took to complete its buildout, not on the buildout requirement listed in the franchise agreement.

- should never be compared to the time an incumbent takes to simply upgrade an existing system.

[170] 47 U.S.C. § 521(6) (2000).

[171] 47 U.S.C. § 541(a)(4)(A) (2000).

[172] David P. Kerr, *Local Cable Overbuilding Issues: The Search for a Level Playing Field*, presented to the Law Seminars International Fourth Annual Local Telecommunication Infrastructure seminar, Aug. 24, 2001, *at* http://www.watoa.org/Level_Playing_Field.pdf (last visited Feb. 8, 2006); United Cable Television Services Corp. v. Dep't of Public Utility Control, 235 Conn. 334, 663 A.2d 1011 (1995) (stating that a comparison between an incumbent and a new entrant is properly made based on the "entire package of terms and conditions required of both cable providers[.]"); Cable Systems of Southern Connecticut, Ltd. v. Connecticut DPUC, 1996 WL 661818 (Conn. Super.) (differentiating a new buildout from an incumbent's system upgrade); Comcast Cablevision of New Haven, Inc. v. Connecticut DPUC, 1996 WL 6611805 (Conn. Super.) (comparing a new entrant's buildout schedule to the actual buildout schedule of the incumbent and its predecessors in interest and taking into consideration the benefits of incumbency); New England Cable Television Ass'n, Inc. v. Department of Public Utility Control, 27 Conn. 95, 717 A.2d 1276 (1998) (holding that the comparison to be made is to the incumbent's original franchise and its actual performance).

- should take into account the risks associated with new entry against an entrenched competitor, as well as the benefits of incumbency.

Although LFAs often require it, nothing in Title VI obligates new entrants to serve the entire area within an LFA's jurisdiction. As we have seen, restricting partial entry only serves as a barrier to entry that hinders competition. Therefore, the FCC should preempt such franchise terms.[173] Similarly, franchise terms that require new entrants to build out unprofitable or sparsely populated areas first, before they can wire other areas, only serve to raise the costs of entry and should also be preempted.

Finally, the FCC should address the barrier to competitive entry posed by the unreasonable nonprice concessions that are often demanded by LFA's. It should issue rules interpreting narrowly the sections of Title VI that allow LFAs to require such concessions. Congress, after all, intended to limit the authority of LFAs to require in-kind contributions not directly related to the operation of PEG channels or the cable system.[174] A reasonable nonprice concession consistent with Title VI must be related to an essential aspect of providing cable service and PEG channels, and cannot include items that are merely tangential to that purpose.

IV. Conclusion

The potential consumer benefits of robust video competition are huge. Widespread video competition could create $7 billion in consumer benefits annually. The benefits take two forms. On average, current cable subscribers in markets without wireline video competition would see their rates fall by about $94 annually, for a total of $6 billion.[175] Consumers who do not currently subscribe would find it worthwhile to do so at the lower, competitive price. These new subscribers would be better off by an average of about $46 annually, the difference between what they would pay for cable

[173] Allowing partial entry is not inconsistent with Section 621(a)(3), which prohibits cable systems from discriminating among subscribers based on income. 47 U.S.C. 541(a)(3) (2000). LFAs can allow partial entry and still ensure that cable systems do not deny service to potential subscribers solely based on "the income of the residents of the local area in which the group resides." *Id.* For example, Texas's statewide franchising system allows for "service area footprint[s]" smaller than the municipality in which they are located. TEX. UTIL. CODE ANN. § 66.003(b)(4) (West 2005).

[174] *See supra*, note 159 and accompanying text.

[175] Our estimate in Table 4 shows that wireline cable competition would reduce cable rates by about $6 billion in markets that currently lack such competition. Dividing that figure by the 64 million subscribers in these markets yields $94.

service and what the service is worth to them. The total value of this benefit to these consumers is approximately $1 billion annually.[176]

The FCC could reasonably decide that at least some video services offered by telephone companies are not subject to cable franchising. However, there are also strong arguments that at least some of these services do require cable franchises. Given this possibility, it is especially critical that the FCC clarify which franchising practices are unreasonable.

The FCC clearly has authority to foster video competition by preempting anticompetitive aspects of local franchise regulation. Key steps the FCC could take include:

1. Declare unreasonable any refusal to grant a franchise justified on the grounds of natural monopoly, reduced investment risk, or rights-of-way management unless the local franchising authority presents overwhelming empirical evidence that the alleged problem exists and cannot be solved in any way other than barring new entry.

2. Require local franchise authorities to explain in writing any refusal to grant a franchise.

3. Preempt aspects of state level playing field laws that force entrants to make the same capital expenditures or cover the same service area as the incumbents.

4. Declare unreasonable any state or local requirement that would force a new entrant to build out its network faster than the incumbent actually and originally built out its network.

5. Declare unreasonable any delay in granting a franchise that exceeds some specified deadline, such as 120 days. Establish simple default conditions under which a new entrant would automatically receive a franchise if the local franchising authority has not acted by the deadline.

6. Declare unreasonable any "nonprice concessions" in franchise agreements that are not directly related to setup or operation of a cable system.

Franchise regulation may not be the only barrier to entry that new video competitors face, but most evidence suggests that it is a significant one. The

[176] Our mid-range estimate in Table 4 shows that consumers who do not currently have cable service are better off by approximately $1 billion when competition lowers the price and more consumers choose to subscribe. The calculations that generated this figure imply that cable subscribership would increase by about 22 million. Dividing $1 billion by 21.65 million yields $46.

FCC should be commended for initiating this proceeding to identify and prevent unreasonable franchising practices.

Appendix I
RSP Checklist

Element	Agency Approach	RSP Comments
1. Has the agency identified a significant market failure?	NPRM identifies potential government failure – unreasonable refusals to grant franchises to new entrants – and offers some evidence that this may be a problem. **Grade: A**	FCC explicitly asks whether franchising process impedes video competition, rather than taking the answer for granted.
2. Has the agency identified an appropriate federal role?	Identifies two federal goals that unreasonable franchising practices might undermine: cable competition and broadband deployment. **Grade: A**	FCC has clear authority to undertake this rulemaking, as the Communications Act enjoins local franchise authorities from unreasonably denying franchises to new entrants.
3. Has the agency examined alternative approaches?	FCC inquires about the merits of rules, guidance, and best practices. NPRM also suggests states can correct problems through legislation. **Grade: A**	Wording suggests that FCC will act, rather than rely on state legislation, if it identifies problems.
4. Does the agency attempt to maximize net benefits?	Seeks to identify any “unreasonable” franchise restrictions.	Focus is on constraining competition as little as possible while accomplishing the franchise authority’s other legitimate goals. This is consistent with maximization of net benefits.

Element	Agency Approach	RSP Comments
5. Does the proposal have a strong scientific or technical basis?	The proposition that entry regulation often constrains competition and harms consumers is well-supported in empirical economic literature. **Grade: A**	
6. Are distributional effects clearly understood?	NPRM tentatively concludes it is not unreasonable for franchising authority to ensure that no citizens are denied service because of their income. **Grade: B**	This conclusion is in federal law. However, local authorities could unreasonably restrain competition using this as the justification. FCC should take action to ensure that this requirement does not get stretched to the point that it deters competition.
7. Are individual choices and property impacts understood?	FCC and federal legislation clearly recognize that incumbents do not have a property right to their customers or a "reliance interest" that justifies continued monopoly. **Grade: A**	This seemingly fanciful concern has actually been a big issue when competition has been introduced in other previously monopolized industries – electricity, and to some extent telecommunications.